

**BEFORE THE
POSTAL RATE COMMISSION**

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POSTAL RATE AND FEE CHANGES, 2000

DOCKET NO. R2000-1

**INITIAL BRIEF OF
UNITED PARCEL SERVICE**

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Dated: September 13, 2000

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**INITIAL BRIEF OF
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INTRODUCTION AND SUMMARY

In this proceeding, the United States Postal Service ("the Postal Service") seeks to continue its march away from its statutory mission "as a basic and fundamental" public service "provided to the people by the Government of the United States," 39 U.S.C. § 101(a), and toward its apparent goal of maximizing volume and market share at the expense of monopoly First Class Mail letter users and private sector businesses.

In particular, the Postal Service has proposed rates under which First Class Mail would (with the sole exception of Express Mail) have a cost coverage significantly higher than any other class or subclass of mail, and significantly higher than the systemwide average. At the same time, it proposes (1) a cost coverage for Priority Mail which would be below that of First Class Mail by more than 14 percentage points -- consistent with its proposal in Docket No. R97-1 to reverse the historic relationship between the cost coverages for those two classes, (2) an Express Mail rate increase that is substantially below the systemwide average, and (3) an almost non-existent

increase of only 1.3% for Parcel Post, with many large Parcel Post shippers receiving no increase at all or even rate decreases.

Under the Postal Service's proposal, attributable costs would shrink to 59% of total costs, and First Class Mail would bear 65% of the remaining unattributed (or "institutional") costs, even though First Class Mail would account for only 51% of total pieces, 17% of total weight, and under 47% of total attributable costs (as defined by the Postal Service).

The Postal Service seeks to achieve these results by once again asking the Commission to abandon the Commission's well-established treatment of mail processing labor costs as fully volume variable -- a change that would shift a significant amount of costs from the attributable cost category into the institutional cost category -- on the basis of a recycled analysis which, in its basic form, has already been rejected by the Commission. It also repeats its previously rejected proposal to depart from the Commission's consistently applied interpretation of the statute, under which the Commission has always marked up all of the costs attributable to each subclass, both the volume variable and the specific fixed costs of the subclass, in apportioning institutional costs.

While the Postal Service has proposed some worthwhile changes, the thrust of its proposals cuts against the congressional intent to protect letter mail and other individual mail users, as well as private enterprise competitors of the Postal Service, from abuse of the Postal Service's monopoly power.

Fortunately, the record contains more than sufficient evidence to enable the Commission to improve the determination and distribution of attributable costs, realign

cost coverages to accord with the statutory non-cost ratemaking factors, and improve faulty aspects of the Postal Service's Parcel Post rate design. Based on that evidence, United Parcel Service ("UPS") submits that the Commission should:

(1) Again reject the Postal Service's flawed proposal to reduce substantially the attribution of mail processing labor costs, instead reaffirm the Commission's well-established attribution of such costs, and distribute those costs to the classes of mail on the basis of the MODS-based approach adopted by the Commission in the last case as modified by the Postal Service in this case;

(2) Mark up all of the costs attributable to each class of mail, including the volume variable and the specific fixed costs of each class;

(3) Revise the Postal Service's treatment of purchased transportation costs to (a) distribute the premium costs of its dedicated air networks to Priority Mail as well as to Express Mail, and (b) allocate the cost of empty space in purchased highway transportation on a basis that better reflects what mail gives rise to the need for the total capacity purchased;

(4) Improve the distribution of attributable City Carrier elemental load costs to parcels and the attribution of advertising costs to Priority Mail, Parcel Post, and Express Mail;

(5) Reject and correct the Postal Service's estimates of Parcel Post revenue, pieces, and weight, including (a) its ill-considered reliance on the hybrid "BRPW/DRPW" approach in place of the long-used DRPW method and (b) its improper treatment of OMAS and Alaska volumes and revenues;

(6) Adopt cost coverages for Priority Mail and for Parcel Post that are more consistent with the statutory goal of protecting captive customers rather than mailers with readily available alternatives;

(7) Correct the Postal Service's Parcel Post rate design errors; and

(8) Approve the Postal Service's proposed contingency allowance.

STATEMENT OF THE CASE

This omnibus proceeding to change postal rates and fees is governed by the Postal Reorganization Act of 1970, as amended, 39 U.S.C. § 101, *et seq.* ("the Act"). The Commission instituted the proceeding by Order No. 1279 (January 14, 2000), and a number of parties (including UPS) intervened.

Hearings were held before the Commission *en banc*, with Chairman Edward J. Gleiman presiding. UPS presented the testimony of four witnesses: Kevin Neels, a Vice President of the consulting firm of Charles River Associates and the Director of that firm's transportation practice; Stephen E. Sellick, a Vice President of PHB Hagler Bailly, Inc. ("PHB"), an economic and management consulting firm; Ralph L. Luciani, also a Vice President of PHB; and Dr. David E. M. Sappington, a Professor of Economics at the University of Florida and Director of that institution's Public Policy Research Center.

THE INTEREST OF UPS

UPS provides a full range of parcel delivery services for the general public. It also provides expedited delivery services for documents. Through its surface and air services, UPS competes with, among other postal services, Express Mail, Priority Mail,

and Standard Mail, particularly Standard Mail (B). UPS and the Postal Service also compete in providing international delivery services.

UPS's primary interest in this proceeding is to ensure fair competition between the Postal Service and its private enterprise competitors through proper application of the ratemaking requirements of the Act, as interpreted by the United States Supreme Court in *National Ass'n of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810 (1983) ("*NAGCP*"). It is UPS's position that the Commission must apply those costing methods and ratemaking principles which best ensure that the Postal Service will be a fair supplier of monopoly services and a fair competitor in the provision of competitive services.

ARGUMENT

I. THE COMMISSION'S PRIMARY MISSION IS TO PROTECT CAPTIVE USERS OF THE POSTAL SERVICE, ESPECIALLY MONOPOLY LETTER MAIL USERS AND OTHER SINGLE PIECE MAILERS.

Congress' overriding intent in adopting the ratemaking provisions of the Postal Reorganization Act and establishing the Commission as an independent body was to guard against the inevitable temptation for the Postal Service to exploit its monopoly over letter mail. As the Senate Report on the Act stated:

The temptation to resolve the financial problems of the Post Office by charging the lion's share of all operational costs to first class is strong; that's where the big money is. The necessity for preventing that imposition upon the only class of mail which the general public uses is one of the reasons why the Postal Rate Commission should be independent of operating management.

S. Rep. No. 912, 91st Cong., 2d Sess. (1970) at 13 ("Senate Report").

The special protection Congress conferred on First Class monopoly letter mail users is evident from the language of the Act. The very first section of the Act, entitled "Postal policy," states as its first policy that the Postal Service "shall be operated as a basic and fundamental service provided to the people by the Government of the United States," and that "The Postal Service shall have as its *basic function* the obligation to provide postal services to bind the Nation together through *the personal, educational, literary, and business correspondence* of the people." 39 U.S.C. § 101(a) (emphasis added). See also, e.g., *id.*, §§ 101(e) (Postal Service shall give "highest consideration" to "important letter mail"), 3623(d) (requiring a class of letter mail with special status).

Two guiding principles emerge from these provisions of the Act and its legislative history. First, "The Postal Service is -- first, last and always -- a public service." H. Rep. No. 1104, 91st Cong., 2d Sess. (1970) at 19, reproduced in 1970 U.S.C.C.A.N. 3649, 3668. While the Act was also intended to permit the Postal Service to operate on a "businesslike basis" to the extent possible, *id.* at 20, 1970 U.S.C.C.A.N. at 3668, the Postal Service was not chartered as a private business, or even as a government corporation. Instead, it is an "independent establishment of the executive branch of the Government of the United States," 39 U.S.C. § 201, and it is made subject to certain requirements and limitations that would not otherwise apply were it to be chartered as a private or government corporation.¹ When its public service nature collides with

1. Many of these are expressly included in the Act. See, e.g., 39 U.S.C. §§ 403(c) (Postal Service shall not "make any undue or unreasonable discrimination among," or "grant any undue or unreasonable preferences to," selected mail users), 410(b) (applying a number of statutes such as the Freedom of Information Act to the Postal Service).

“businesslike” methods, the public service nature of the Postal Service takes precedence.

Second, the Act is designed to protect “the ordinary mailer.” Senate Report at 3 (the Act’s “objective is to establish a postal structure and a method of operating” that is subject to “broad policy guidelines designed to protect the ordinary mailer”). While the Postal Service has the responsibility to “provide types of mail service to meet the needs of different categories of mail and mail users,” 39 U.S.C. § 403(b)(2), Congress has shown special concern for protecting those types of mail “which the general public uses.” Senate Report at 13.

To implement these policies, Congress adopted the ratemaking factors set forth in Section 3622(b) of the Act, 39 U.S.C. § 3622(b). Thus, those factors should be interpreted and applied in a way that protects captive users and the ordinary single piece user.

The Postal Service’s proposals are, by and large, contrary to these principles. Instead, the Postal Service apparently seeks to gain volume for volume’s sake and to protect and increase its market share, even if doing so means that First Class Mail users or single piece users must pay a greater share of the Postal Service’s costs. A prime example of this is the Postal Service’s proposal that competitive Parcel Post enjoy one of the lowest rate increases proposed – 1.3%, contrasted with a systemwide average increase of 6.5% – and that even within Parcel Post, almost the entire rate increase be imposed on single piece users while large dropshippers receive little or no increase, or even rate decreases.

The Postal Service would achieve this result by converting attributable costs into institutional costs and then imposing the lion's share of institutional costs on First Class Mail users and single piece mailers in other classes. That is contrary not only to the central policies embodied in the Act, but also to the specific ratemaking criteria adopted to implement those policies.

II. THE COMMISSION SHOULD REJECT PROPOSALS TO REDUCE ATTRIBUTABLE COSTS IN THE ABSENCE OF CLEAR PROOF THAT THE COMMISSION'S LONG-ESTABLISHED METHODS OF ATTRIBUTION ARE NOT SUPPORTABLE.

A. The Postal Service's Proposal To Mark Up Volume Variable Costs Rather Than Volume Variable And Specific Fixed Costs Should Again Be Rejected.

The Postal Service again proposes that the Commission mark up only volume variable costs in determining the contribution to institutional costs for each subclass of mail. USPS-T-32 at 16-19 (Mayes). The Commission explicitly rejected that approach in Docket No. R97-1, *Postal Rate & Fee Changes, 1997*, Docket No. R97-1, Opinion and Recommended Decision ("R97 Decision") at 1/232-37, and it should do so again in this case.

Section 3622(b)(3) of the Act sets forth "the requirement that each class of mail or type of mail service bear the direct and indirect postal costs attributable to that class or type plus that portion of all other costs of the Postal Service reasonably assignable to such class or type." 39 U.S.C. § 3622(b)(3). Unlike the other factors, Section 3622(b)(3) is a requirement, not a discretionary consideration; it is "the *only* immutable pricing requirement of the Act." *Postal Rate & Fee Changes, 1983*, Docket No. R84-1,

Opinion and Recommended Decision at 259 (¶ 4001) (emphasis added). See also *Postal Rate & Fee Changes, 1994*, Docket No. R94-1, Opinion and Recommended Decision at IV-17 (¶ 4046) (“[T]he first imperative of rate-making under the Postal Reorganization Act is the recovery of attributable costs in rates”).

The Supreme Court has held that the Act “requires that all costs reliably identifiable with a given class, *by whatever method*, be attributed to that class.” *NAGCP*, 462 U.S. at 820 (footnote omitted) (emphasis added). The Court delivered a clear message -- if a particular cost is “capable of being considered the result of providing a particular class of service,” the Commission should attribute that cost. *NAGCP*, 462 U.S. at 833-34 n.29. Moreover, in deciding what costs are attributable, the Commission must strive to meet “Congress’ broad policy . . . to mandate a rate floor consisting of all costs that could be identified . . . as causally linked to a class of postal service.” *Id.* at 833.

Historically, the Commission has based its attributable cost determinations primarily on findings of volume variability, supplemented by instances where certain fixed costs, known as “specific fixed costs,” are incurred to provide a specific subclass of mail. Yet, the Postal Service again proposes in this case, as it did in the last one, that “attributable costs” be limited to volume variable costs. The Commission decisively rejected that argument in the last case. The Postal Service has not presented any new

evidence to disturb that finding. Thus, the Commission should again reject the Postal Service's attempt to limit the attributable cost markup base to volume variable costs.²

The Postal Service's argument is contrary to the plain language of Section 3622(b)(3). That section establishes a two-step ratesetting process. *NAGCP*, 462 U.S. at 823-25, 833-34. The first step mandates a rate floor for each class of mail consisting of all of the costs attributable to the class. *Id.* Those costs include specific fixed costs. The language requiring that each class of mail "bear" the costs attributable to it reflects Congress' intent to prevent cross-subsidy by building rates on top of the attributable cost floor. *Id.* at 829 n.24. Once the Commission determines "the direct and indirect postal costs attributable to" each class of mail, it must then assign to each class some "portion of all *other* costs of the Postal Service reasonably assignable to such class." 39 U.S.C. § 3622(b)(3) (emphasis added). As the Commission has explicitly stated, "Congress expected [an attributable cost floor] to be constructed for each class [with] *the rate built upon it.*" *Postal Rate & Fee Changes, 1987*, Docket No. R87-1, Opinion and Recommended Decision at 103 (¶ 3009) (emphasis added).

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2. The Act requires that the costs attributable to "each class of mail" be identified. 39 U.S.C. § 3662(b)(3). In other words, the relevant "unit" for measuring attributable costs is the entire class of service. It is UPS's view that the attributable costs of a class of mail include the incremental costs of the class. See Tr. 31/15238-39. The Commission had concerns in the last case about the accuracy of the Postal Service's incremental cost estimates in that case, and it therefore declined to use those estimates as the attributable cost markup base. R97 Decision at 1/248-50, ¶¶ 4053-56. However, once the Commission is comfortable that incremental cost estimates are sufficiently accurate, it should use incremental costs as the markup base. Tr. 15/15239.

In short, Section 3622(b)(3) divides postal costs into two types, "attributable" costs **plus** "other" costs which are to be assigned on top of the attributable costs on the basis of the non-cost factors of the Act. The dictionary defines the preposition "plus" as meaning "increased by," or "with the addition of." *Merriam Webster's Collegiate Dictionary* at 896 (10th ed. 1997). There is no gray category of costs which are caused by a class of mail but which may be assigned to other classes of mail on the basis of non-cost considerations, such as demand or "economic value of service." Thus, the second step of the ratesetting process mandates the assignment of only those "costs remaining above the rate floor." *NAGCP* at 829 n.24, 834.

UPS witness Sappington explained the importance of making sure that each class covers its attributable costs plus a markup on top of those costs. Tr. 31/15233-39. Given the language of the statute and the sound policy reasons he advanced, the Commission should again reject the Postal Service's proposal to shrink the markup base and should carefully scrutinize any suggestion that attributable costs should be reduced.

B. The Commission Should Base Its Recommended Rates On FY1999 Cost Data To The Maximum Extent Possible In Order To Ensure A Proper Determination Of Test Year Attributable Costs.

The Postal Service bases its requested rates on cost data for FY1998. As a result, the Postal Service estimated costs for FY1999 and then for FY2000 in rolling forward its Base Year FY1998 costs to the Test Year (FY2001).

However, not long after this proceeding began, actual audited cost data for FY1999 became available. Consequently, the Commission asked the parties whether

the Commission should (1) continue to rely on the 1998 data and estimates for the ensuing years, or (2) use the actual FY1999 data as the basis for the Test Year estimates.

UPS submits that the Commission's question almost answers itself. Virtually all parties agreed that the actual FY1999 data should be used to some extent, if only as a check on the accuracy of the estimates derived from the 1998 data. However, many parties were reluctant to endorse the full-scale substitution of FY1999 for FY1998 as the Base Year in this case, citing concerns over the feasibility of doing so within the constraints of the schedule for the proceeding.

It is now clear that, as the result of a great deal of work by all of the parties -- and especially the Postal Service -- it is certainly feasible to substitute FY1999 for FY1998 as the Base Year for the Commission's rate recommendations. The Commission and the Presiding Officer have successfully accommodated the due process concerns expressed previously by a number of parties. Given these circumstances, UPS submits that it is now incumbent on the Commission to use, to the maximum extent possible, the actual FY1999 cost data as the starting point for determining its recommended rates.

The Commission's goal is to recommend rates that balance "as nearly as possible" the Postal Service's actual income and costs. *United Parcel Service, Inc. v. United States Postal Service*, 184 F.3d 827, 834 (D.C. Cir. 1999) ("*UPS*"), quoting the Senate Report at 14-15. See also 39 U.S.C. § 3621 (revenues should equal expenses "as nearly as practicable"). Data that is both actual and recent almost certainly yields the most reliable and accurate rates.

Courts disfavor the use of estimates when actual data is available. See *West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 79, 81-82 (1934), cited in *UPS*, 184 F.3d at 835. In addition, the courts almost always find that it is preferable to use the most recent data available. See, e.g., *Alvarado Community Hosp. v. Shalala*, 155 F.3d 1115 (9th Cir. 1998) (remanding decision of Secretary of Health and Human Services for redetermination using more recent data). Under these precedents, FY1999 should be used as the Base Year because it is the most recent actual data.

Inaccuracies in the Postal Service's FY1998-based estimates for FY1999 could result in a Commission recommended decision that is not based "on such relevant evidence as a reasonable mind might accept as adequate to support [the Commission's] conclusion." *UPS*, 184 F.3d at 835. That appears to be the case with respect to a number of mail classes, where the actual FY1999 cost data reveals substantial inaccuracies in the Postal Service's FY1998-based estimates for FY1999. As NAA has rightly noted, "some of the older estimates are materially off the mark." NAA Comments in Response to Notice of Inquiry No. 2 (May 8, 2000) at 2. For example, the Postal Service has apparently underestimated FY1999 attributable costs per piece using the Commission's methodology by 6.39% for Priority Mail and by 2.07% for Express Mail. Notice of Inquiry No. 2 Concerning Base Year Data, Attachment 1, page 1 (April 21, 2000). These inaccuracies approach the magnitude of the contingency requested by the Postal Service.

In the case of Priority Mail, the attributable cost per piece discrepancy by itself is substantial. And it must be remembered that marking up incorrect measures of attributable cost magnifies the error. Furthermore, in the case of a service such as

Parcel Post where the cost coverage is razor thin, even a small discrepancy between estimated and actual costs may be enough to drive rates below attributable costs.

All of the parties have been given the opportunity to present supplemental testimony using the actual FY1999 data and to conduct cross-examination on that testimony. UPS has presented supplemental testimony illustrating the impact of UPS's costing and ratemaking proposals using the actual FY1999 data. See Tr. 37/16952-53, 38/17239-57. The succeeding sections of this brief show that the costing and ratemaking methods which form the basis for those calculations should be adopted.

Accordingly, the rate increases shown by UPS witness Luciani in his supplemental testimony using actual FY1999 data should form the basis for the rates recommended by the Commission.

C. The Postal Service's Latest Study Of The Volume Variability Of Mail Processing Costs Does Not Provide A Basis For Rejecting The Commission's Well-Established Treatment Of Those Costs As 100% Volume Variable.

In Docket No. R97-1, the Commission identified a number of "disqualifying defects" in the Postal Service's volume variability analysis of mail processing labor costs. R97 Decision at 1/65-67. Among those deficiencies were error-ridden data, the excessively short run nature of the analysis, and the resulting failure of the analysis to capture the indirect effects of volume on mail processing costs. *Id.*

In this docket, Postal Service witness Bozzo has failed to rehabilitate that analysis. Dr. Bozzo is no more successful than was Dr. Bradley in providing justification for departing from the Commission's long-held conclusion that mail processing labor costs are essentially 100% volume variable. Quite the contrary, as

UPS witness Neels testified, "the record is more complete here and provides more support for [the Commission's long-standing] conclusion." Tr. 27/13069.

**1. The Data Relied on by the Postal Service
Continues to Exhibit Serious Problems of the
Type Identified by the Commission in Docket
No. R97-1.**

The suitability of the MODS data relied on by the Postal Service was questioned by the Postal Service itself as long ago as Docket No. R84-1. See Tr. 46/22107. When the data was provided publicly for the first time in Docket No. R97-1, the Commission lamented the fact that "a dirty sample such as MODS . . . panel data confronts the econometrician with problems that have many bad solutions and no good ones." R97 Decision, Vol. 2, App. F at 27. Specific data problems identified by the Commission in that docket included reporting gaps as well as instances where a particular site reported piece handlings for only one period out of the many periods covered by the data. R97 Decision, Vol. 2, App. F at 26. Similar problems exist in this case. See Tr. 27/12796-802, 46/22324-46.

The deficiencies of the underlying data have significant ramifications for the Postal Service's econometric estimates. A data set must be "sufficiently . . . complete and error-free to give an econometrician a good opportunity to obtain reliable estimates of variabilities." Tr. 27/13066-68. That is not the case here.

Under Dr. Bozzo's own tests of data quality, the data for the Manual Parcels and Manual Priority cost pools do not qualify as "average quality" or "routine" data. USPS-T-15 at 106. See also Tr. 38/17315, 17386, 27/13005. The Manual Parcels data has frequent gaps. Tr. 27/12797. Moreover, there is evidence of the commingling of

Manual Parcels data with SPBS data. *Id.* at 12797-98.³ The Priority Mail data series also has serious gaps. Tr. 15/6387, 6388, 27/12799.⁴ In both of these cases, the data are manually logged, which increases the chances of erroneous data reporting. Tr. 27/12798, 12799.

Dr. Bozzo's measures of data quality are incomplete. He only counts the observations eliminated by his threshold and productivity scrubs. He ignores records with missing data and records where the data are internally inconsistent (e.g., where FHP exceeds TPH, or where TPH exceeds TPF). On cross-examination, he confirmed that his analysis used only about 67% of the possible observations for Manual Parcels, for example. Tr. 15/6428. When almost 35% of the data must be eliminated, one wonders how much of the remaining data is infected with undetected errors. As Dr. Neels noted, ". . . given the nature of the manual data entry problems cited by Dr. Bozzo, it is possible that these series may contain other errors that are undetectable by the simple editing screens he uses." Tr. 27/12798. *See also id.* at 12799-800.

Data quality issues are not limited to the Manual Parcels and Priority Mail cost pools. The lower error rates for other pools "actually understate the degree of error

3. The Postal Service's strained attempts to explain away one specific example cited by Dr. Neels (Tr. 27/12797-98) are unconvincing. *See* Tr. 15/6387-88. Regardless of the explanation for this particular site, the fact remains that even in the case of that site, the data shows hours worked in the Manual Parcels pool but no TPH count for that pool. Tr. 27/13002. Whatever the correct explanation, the conclusion is unmistakable: ". . . there are gross errors in the manual parcel data for" the site. *Id.* at 13003.
4. These gaps have been explained as resulting from the absence of an employee to manually log the data. Tr. 15/6387, 6388.

because they do not count as erroneous those observations with erroneously recorded zero piece handlings.” Tr. 27/12796-97. See also Tr. 46/22323-36.

Dr. Bozzo’s use of a fixed effects estimator does not solve the data quality problem, since it is likely that the data errors do not vary systematically across sites. Tr. 27/12800-01. In such a circumstance, fixed effects estimation “cannot solve the errors-in-variables problem.” *Id.* at 12801. See also Tr. 46/22116.

In his rebuttal testimony, Dr. Bozzo attempts to explain away the data quality problems. Tr. 46/22178-81. However, he cannot affirmatively state that the errors Dr. Neels identifies are not in fact data reporting errors; rather, the best he can say is that they are not *necessarily* data reporting errors. Tr. 46/22178.

The inescapable fact is that much of the data just does not make sense. Tr. 27/12921, 12925, 12926, 46/22324-36. For example, FHP values inexplicably exceed TPH values, TPH values are recorded with no corresponding workhours, and workhours are recorded with no corresponding TPH count. Tr. 27/12923-24, 46/22324-36. Gross data errors go as high as 22% for the Priority cost pool and 28% for Manual Parcels. Tr. 27/12926. The existence of data errors of this type, magnitude, and frequency seriously undermines confidence in the entire MODS data set.

In short, the magnitude of the detected and suspected data problems indicates that the overall data set is not suitable to serve as a basis for rejecting thirty years of precedent. As a result, the Commission should adhere to its consistent treatment of mail processing labor costs as fully volume variable.

**2. Dr. Bozzo's Reliance on Piece Handlings as
a Proxy for Volume Should Be Rejected.**

As in Docket No. R97-1, the Postal Service persists in using an inappropriate cost driver for determining the volume variability of mail processing costs. The goal of volume variability analysis is to determine the extent to which costs change as a result of changes in **volume**. The main obstacle to accurate estimation of that variability has been, and continues to be, the identification of a proper cost driver and the absence of a sufficiently good measure of mail volume. Tr. 27/12802-05, 12848-49, 13067. The Postal Service continues to back an unsuccessful candidate in TPH.

Dr. Bozzo's use of piece handlings as a proxy for volume assumes that each additional piece of mail will generate the same number of additional piece handlings, on average, within a subclass. Tr. 27/12803. However, there is no empirical evidence validating this key "proportionality assumption."⁵ On the contrary, Dr. Neels' empirical investigation of the empirical relationship between TPH and FHP – a "noisy" measure of volume, but one that, unlike TPH, is at least conceptually akin to the appropriate volume measure, Tr. 27/12805 -- indicates that an increase in volume leads to a **disproportionate** increase in piece handlings. Tr. 27/12805-07. In other words,

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5. As Postal Service witness Bradley testified in the context of the volume variability of purchased transportation costs, a disproportionate relationship between the measured cost driver and volume requires that the elasticity estimates be adjusted to reflect that relationship. Tr. 43/18388. When Dr. Neels made that adjustment in the case of mail processing, he arrived at variabilities close to or in excess of 100%. Tr. 27/12807-08. Dr. Bozzo attacks the adjustment. Tr. 46/22159-71.

empirical analysis undermines the proportionality assumption, which is central to Dr. Bozzo's approach. Tr. 27/12805.⁶

In his rebuttal testimony, Dr. Bozzo relied on the A.T. Kearney Data Quality Study to support his view that the Postal Service's cost driver/distribution key method of measuring volume variable costs is appropriate. Tr. 46/22175-77. Specifically, he cited the Data Quality Study as finding the cost driver/distribution key method to be "logical" and "correct." Tr. 46/22176.

Dr. Bozzo's argument is a red herring. While the Data Quality Study endorsed the use of a cost driver/distribution key approach, that study does not provide the ringing endorsement of Dr. Bozzo's particular models and cost driver which he apparently seeks to ascribe to it. While the cost driver/distribution key approach is appropriate in theory, its value in any particular instance is limited by the accuracy of the data used and the appropriateness of the cost driver.⁷

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6. Even if Dr. Neels' estimate of the TPH/FHP elasticity overstates the true elasticity, Dr. Bozzo's calculation understates that elasticity. See Tr. 46/22101-02. Given the spread between those bounds, one cannot comfortably conclude that the relationship is proportional.
 7. The Postal Service tries to paint Dr. Neels as an opponent of the cost driver/distribution key approach. That too is a red herring. Dr. Neels' criticisms are not of the approach, but rather apply to Dr. Bozzo's use of TPH as the cost driver and Dr. Bozzo's justification of his specific analysis on the basis of "simplicity." Tr. 27/12804. In other words, Dr. Neels disagrees with Dr. Bozzo's *implementation* of the cost driver/distribution key method, not with the method itself.

Time Warner witness Stralberg's arguments in his rebuttal testimony do not provide a basis for adopting TPH as a proxy for volume.⁸ First, Mr. Stralberg argued that Dr. Neels has failed to adequately address the fact that the TPH/FHP ratio will vary with plant size because of network characteristics. Tr. 38/17278. He suggested that Dr. Neels should have controlled for the size of a plant's service area. *Id.* However, Dr. Neels did control for number of delivery points, a measure of service area size, and therefore adequately dealt with any concerns on this point. See Tr. 27/12806.

Mr. Stralberg also argued that TPH is more clearly related to workload than is FHP. Tr. 38/17288. This argument misses the point. Dr. Neels does not dispute that TPH may be more closely related to workload than is FHP. His testimony is that FHP is conceptually more closely related to **volume**, the variable of interest, and that TPH is not a good proxy for volume.

The bottom line is that for TPH to be a suitable proxy for volume, it must be accurately measured and it must vary in direct proportion to volume. These are empirical issues. The empirical analyses in the record indicate that TPH fails both of these tests.

3. Dr. Bozzo's Analysis Ignores the Postal Service's Ability to Adjust to Changes in Volume.

Even aside from these defects (which apply to a short run as well as to a longer run analysis of mail processing costs), the Postal Service does not adequately respond

8. Mr. Stralberg readily acknowledged that he is not an econometrician. Tr. 38/17291. Thus, his comments on whether Dr. Bozzo's models contain the proper variables are of limited utility.

to the Commission's concern in its R97 Decision that the volume variability analysis in that case was not sufficiently long run to measure accurately the Postal Service's complete response to changes in mail volume. R97 Decision at 1/79. The Commission there stated that "the time period that is appropriate for volume-variable cost analyses is that the volume-variability of costs should reflect the length of time that the Commission's recommended rates would be expected to be in effect." *Id.* It rejected the Postal Service's elasticities because they were "not estimates of volume-variability for the period of time the recommended rates would be in effect." R97 Decision at 1/81.

While Dr. Bozzo's analysis is less "short run" than was the R97-1 analysis, he and other Postal Service witnesses readily acknowledge that it is a short run analysis. Tr. 38/17364, 17385. Indeed, it is still too short run.

Dr. Bozzo attempts to cure the deficiencies in the R97-1 model "by including additional lagged values of piece handlings . . . by including up to four quarterly lagged values of piece handlings." Tr. 15/6405. This falls far short of the three year rate cycle period referred to by the Commission in Docket No. R97-1. R97 Decision at 1/80.⁹ As a result, Dr. Bozzo is not capturing the effects of volume on all factors of production that vary in the long run. Tr. 15/6406.

9. It is UPS's position that using the "rate cycle" to determine whether an analysis sufficiently allows the relevant factors of production to vary or adjust to volume changes is not the correct test: the length of the "rate cycle" can change depending on many factors, including the whim of the Postal Service. However, that issue need not be decided in this case, since in any event the Postal Service's analysis is too "short run."

That is a crucial oversight. As Dr. Neels testified, the Postal Service can change its mail processing capabilities to respond to volume changes in a number of ways -- by adjusting staffing levels, by changing levels of mechanization and automation, and by constructing, expanding, or modifying mail processing plants. Tr. 27/12776-90. Dr. Bozzo's study focuses on changes in staffing levels. Even assuming that his analysis were to capture the longer term aspects of Postal Service staffing operations -- and it does not -- it fails to capture the impact of volume on longer term changes in the mix of resources used to adapt to volume changes.

For example, one area affected by mail volume is decisions on capital expenditures for mail processing equipment. The testimony of the Postal Service's own witnesses shows that the decision to add specific MODS activities to mail processing plants, to install new equipment, to upgrade existing equipment, or even to invest in the development of new types of equipment is affected by the need to accommodate volume growth. See, e.g., USPS-T-10 at 4-9, 10, 12-15, 20, 31-32 (Postal Service witness Kingsley). A perfect example was provided by Postal Service witness Dowling on rebuttal:

"The introduction of the Enhanced Carrier Route subclass in Standard A and drop ship incentives for Standard A and Periodicals attracted additional flats volume to destination SCF and delivery units, thereby bypassing flats distribution or bundle sorting operations Despite these rate incentives, moreover, non-carrier route flats volumes continued to grow. Rather than serve this growth by adding flats distribution capacity using outmoded technology, we elected to **increase capacity using next generation technology**"

Tr. 46/20475 (emphasis added). Mr. Stralberg also agreed that volume affects decisions about what mail processing technology to use. Tr. 38/17293-94.

Decisions regarding the installation or upgrading of mail processing equipment are often driven by the need to accommodate growth in volume. See USPS-T-10 at 12-15, 31-32; Tr. 27/12777. Thus, MODS data for 1993 through 1998 shows substantial increases in the use of significant mechanized MODS activities. See Tr. 27/12778-80. The MODS activities data also shows “increasing reliance on mechanized processing and a gradual decline in the proportion of sites relying entirely on manual processing.” Tr. 27/12783. It is no accident that larger mail processing plants use different technology than smaller plants; investments in equipment make sense only when volume reaches a certain level. Tr. 38/17293-94 (Stralberg).

By using “a great deal of econometric firepower,” Tr. 27/12788, Dr. Neels established that “the available data show a systematic relationship between the mix of activities present at a plant and the volume of mail that it processes.” Tr. 27/12787. The Postal Service’s analysis fails to capture this impact of volume on shifts in the mix of activities and technology used to process increased mail volumes. As Dr. Neels testified, “[i]t should come as no surprise to anyone involved in this proceeding that mechanization decisions are closely related to mail volume, and that mechanization is one of the important ways in which the Postal Service accommodates growth in mail volume.” Tr. 27/12788. The failure of the Postal Service’s analysis to capture this effect is fatal.

Finally, the Postal Service’s analysis fails to capture the impact of volume on the construction, expansion, and modification of the space needed to accommodate mail processing activities. Dr. Bozzo’s analysis includes a number of new facilities that opened during the time covered by his data, while other existing facilities were added to

MODS, thereby indicating an increase in the volume handled by those facilities. Tr. 27/12789. He acknowledged that "additions of facilities to MODS are most commonly related to expansions of the facilities to include automated sorting equipment." Tr. 15/6389. Postal Service witness Kingsley also described the modification or expansion of processing plants to accommodate changes in mail volume. USPS-T-10 at 32-35. See also USPS-T-16 at 14-15.

These responses to changes in volume are not captured by Dr. Bozzo's analysis. Since his analysis ignores the full spectrum of the Postal Service's responses to volume changes, it understates the true volume variability of mail processing labor costs. It is not surprising, then, that it produces counterintuitive results. The analysis indicates, for example, that manual operations enjoy economies of scale greater than those for mechanized operations, *i.e.*, "that manual processing eventually becomes less expensive on a per piece basis than mechanized and automated activities." Tr. 27/12811.

Such results are contrary to common sense. Something is seriously wrong. Clearly, the Postal Service's proposed volume variabilities are incorrect.

4. Dr. Neels' Alternative Analyses Suggest that the Commission's Established Treatment of Mail Processing Labor Costs Is Correct.

Dr. Neels' alternative analyses of mail processing costs produce variabilities close to or in excess of 100%. While not definitive, these results corroborate the Commission's long-held conclusion that mail processing labor costs are fully volume variable.

Dr. Neels' aggregate time series analysis captures the interrelationships between MODS cost pools, interrelationships which the Postal Service's witnesses and Mr. Stralberg acknowledge to exist but which are largely ignored by Dr. Bozzo's analysis. Tr. 27/12793. *See also* Tr. 38/17286, 17299-300. The aggregate analysis suggests volume variabilities close to or in excess of 100%. Tr. 27/12839-40.

Dr. Neels also aggregated cost pools by shape for letters, flats, and parcels. In addition, he adjusted for the elasticity of TPH with respect to FHP, the more conceptually accurate measure of volume.¹⁰ That approach takes into account Postal Service decisions concerning workload allocation across MODS groups, whether to automate or mechanize mail sortation, and changes in activity mix over time. Tr. 27/12936-38. Again, the results almost uniformly suggest volume variabilities in excess of 100%.¹¹

* * *

The major disqualifying defects which the Commission found in the Postal Service's Docket No. R97-1 analysis by and large remain in Dr. Bozzo's analysis. Among other things, that analysis relies on seriously questionable data; it is based on an apparently erroneous assumption that piece handlings are proportional to volume;

10. As noted previously, this is the approach advocated by Postal Service witness Bradley in his purchased transportation testimony.

11. The Postal Service argues that data aggregation hides helpful information. Tr. 46/22066-68, 46/22150-58. That certainly can be the case. *See* Tr. 31/15036-37. However, if one is looking for a systemwide or facility-wide variability, then a systemwide or facility-wide model specification makes sense.

and it ignores longer-run structural changes, at both the facility level and the system level, that reflect the impact of volume changes on mail processing costs.

The Postal Service's mail processing volume variability estimates continue to be unreliable. Accordingly, the Commission should continue to adhere to its consistently held conclusion that mail processing labor costs are fully volume variable.

D. The Postal Service Should Not Be Permitted To Arbitrarily Dictate, As It Alone Sees Fit, The Level Of Attributable Advertising Costs.

In its original filing, the Postal Service estimated Test Year advertising costs at \$270 million before contingency. Tr. 46/20989. As a result of interrogatories from UPS, Ms. Kay revised her original testimony and dramatically increased the amount it attributed to the competitive classes of mail. Specifically, it attributed \$71.2 million to Priority Mail, \$18.5 million to Parcel Post, and \$1 million to Express Mail. Tr. 25/11776-77. Those attributions were derived from the percentages of advertising costs which the Postal Service says it spent to advertise those services in FY1998. Tr. 46/20990.¹²

In the Postal Service's FY1999 analysis, estimated Test Year advertising costs plummeted by 42%, to approximately \$160 million before contingency. Tr. 46/20989. The Postal Service drastically reduced not only the absolute amount of estimated Test Year advertising costs, but it also eliminated all advertising costs for Express Mail and reduced the percentage share allocated to Parcel Post by 97% (to almost zero). Tr. 38/17243.

12. The process used to derive these percentages is far from scientific. See Tr. 21/9364-66, 46/20990-92. It can be easily manipulated.

These revisions demonstrate the arbitrariness of the Postal Service's "method" of allocating advertising costs. The Postal Service has provided no information whatever to indicate that the Test Year advertising costs for Express Mail and Parcel Post will decline to zero or almost zero.¹³

Common sense establishes that the bulk of the Postal Service's advertising efforts focuses on its competitive products, especially Priority Mail. In the absence of any detailed justification for departing from Ms. Kay's revised FY1998 advertising cost allocations and regardless of whether the Commission uses FY1998 or FY1999 as the Base Year for its recommended rates, the Commission should attribute to Priority Mail, Express Mail, and Parcel Post the amounts attributed to them by Ms. Kay when she revised her original testimony on March 13, 2000.

At the very least, should the Commission base its recommended rates on FY1999 data and accept the Postal Service's advertising cost allocations based on the data for that year, it should take into account in setting the cost coverages for the competitive classes of mail that the Postal Service's FY1999 data almost certainly understates the likely Test Year advertising costs attributable to those classes.

13. Indeed, one wonders why **any** advertising costs are allocated to the non-competitive classes of mail. "Institutional" advertising that may not feature a specific product can only benefit the Postal Service's competitive services, since monopoly users have little choice but to use the Postal Service. See Tr. 31/15496-97.

III. THE RECORD CONTAINS A NUMBER OF PROPOSALS THAT WOULD IMPROVE COST ATTRIBUTION AND DISTRIBUTION SO THAT COSTS WILL BE MORE ACCURATELY TRACED TO THE USERS WHO CAUSE THEM.

While not all of the defects in the Postal Service's attribution and distribution of attributable costs can be corrected, the record does contain evidence sufficient to correct a number of those defects. We begin, however, with one area where the Postal Service has improved the distribution of attributable costs.

A. The Commission Should Again Adopt The Postal Service's MODS-Based Approach To Distribute Mixed Mail And Overhead Mail Processing Labor Costs, As Modified By Improvements Proposed By The Postal Service And By UPS.

In Docket No. R97-1, the Postal Service formulated a new approach to distributing mail processing labor costs. That approach was adopted by the Commission. It should be applied again in this proceeding, with the additional improvements proposed by Postal Service witnesses Degen and Van-Ty-Smith, but on the basis of 100% volume variability for mail processing labor costs.

UPS witness Sellick, both in his direct testimony (Tr. 27/13124-27) and (as requested by the Commission) in his supplemental testimony (Tr. 37/16952-53), has calculated the impact of this modified MODS-based approach given the Commission's traditional conclusion that mail processing labor costs are fully volume variable. He has also adapted the Postal Service's improvements "to address the 'migration' of certain Administrative and Window Service costs to the Mail Processing component of Cost Segment 3 and the distribution of costs in certain 'allied' pools" Tr. 27/13124.

Witnesses Cohen and Stralberg contested the adoption of the MODS-based distribution approach in Docket No. R97-1, but they have largely accepted that approach in this case. However, they, along with Parcel Shippers Association ("PSA") witness Glick, propose a different distribution method for certain "mixed mail" and "not handling mail" costs. The Postal Service has effectively rebutted those arguments. See Tr. 38/17325-29.

Accordingly, the Commission should adopt the distributions of mail processing labor costs set forth by Mr. Sellick in his testimony on this subject. See Tr. 27/13127 (FY1998 data); 37/16953 (FY1999 data).

B. The Network Premium Associated With The Postal Service's Dedicated Air Networks Should Be Attributed To Priority Mail As Well As To Express Mail.

Since Docket No. R97-1, Priority Mail has been the "stowaway" avoiding payment for premium passage aboard the Postal Service's dedicated air networks.¹⁴ In its decision in that case, the Commission attributed the dedicated air network premium solely to Express Mail, based on one unchallenged sentence from one Postal Service witness. R97 Decision at 1/221-22. This represented a sharp break from prior practice, under which the Commission had made a conscious decision in both Docket No. R90-1 and R94-1, over the objections of more than one party, to attribute the premium to both Express Mail and Priority Mail. See R97 Decision at 1/221-22, ¶¶ 3398-3400.

14. The network premium is the difference between (1) the actual cost of the Eagle and the Western networks and (2) the imputed commercial air equivalent for the same transportation; in FY1998, the premium was \$124.7 million. USPS-T-19 at 1; Tr. 32/15996-97.

UPS witness Neels has established in this docket that the network premium should be attributed to both Priority Mail and Express Mail. Tr. 32/15996-16004. Indeed, the evidence in this case establishes beyond doubt that the Commission's pre-Docket No. R97-1 treatment is the correct one.

Priority Mail is by far the largest user of these networks. In FY1998, more than 47% of the volume on the Eagle network and almost 54% of the volume on the Western network was Priority Mail. Tr. 32/15998-99. In comparison, Express Mail represented only 24% of the volume on the Eagle network -- about half of the Priority Mail volume -- and a mere 9% of the volume on the Western network. *Id.* These facts alone establish that it "would be incongruous" to attribute to Express Mail the entire premium, with the result that 60% of the cost of these networks would be paid by Express Mail when it represents only 22% of the volume carried on them, while Priority Mail represents well more than twice as much (48%) of the volume on these networks. Tr. 32/16004.

There is a fair amount of discussion in the record concerning whether the networks are sized solely to meet the requirements of Express Mail. Most of that discussion is a red herring: given the small amount of Express Mail volume moving on them, it just is not credible to argue that these networks are sized solely to meet Express Mail's needs.

In any event, even ignoring the relatively small amount of Express Mail carried on the networks, the evidence presented by the Postal Service does not credibly establish that the networks are sized solely to meet the requirements of Express Mail. For example, Postal Service witness Pickett states that "[T]he use of Boeing 727s on the WNET is a consequence of a conscious effort to efficiently operate dedicated air

networks in unusual conditions.” Tr. 43/18531. This does not demonstrate that 727s are used solely to efficiently operate the networks *for Express Mail*. He also states that “The size of the Boeing 727 all but eliminates” the concern over “somewhat predictable” holiday volume swings. Tr. 43/18536. He does not say that the 727 is necessary to eliminate a concern about the ability to handle only the “somewhat predictable” *Express Mail* holiday volume swings.

Mr. Pickett is carefully tap-dancing around the issue. There is no hard evidence -- only the Postal Service’s unsupported assertions -- to suggest that the networks are sized solely for Express Mail.¹⁵

Rather than provide hard evidence, Mr. Pickett goes through an account of why the Postal Service believes “turboprops are simply inadequate for the WNET.” Tr. 43/18532-34. Again, this does not address the issue of whether the networks are sized solely for Express Mail. Even if it did, Mr. Pickett admits that prior to August 1999, the Postal Service used a “mix of planes . . . DC-9s, Metro IIIs, and Beechcraft 1900,” some of which were turboprops, on the Western network. Tr. 43/18558. As Dr. Neels testified, if turboprops are “simply inadequate,” jets smaller than the 727 could meet the need if Express Mail’s volume were the only determining factor. Tr. 32/16133-34. Similarly, Mr. Pickett testified that “a contractor **could have** offered a mix of aircraft, [but] the use of a single aircraft greatly simplifies operations.” Tr. 43/18534-35

15. APMU witness Haldi similarly provides no evidence to show that the air network is sized only for Express Mail. Rather, his discussion of whether it makes sense to use larger rather than smaller aircraft in these networks (Tr. 45/19595-603) is largely irrelevant in light of the fact that 78% of the volume carried is mail other than Express Mail.

(emphasis added). Simplification of air network operations does not in any way justify distribution of the entire premium to Express Mail.

The evidence indicates that handling Express Mail timely is not the only reason the networks are configured as they are. Internal Postal Service deliberations on how to configure the Western network indicate that improved service for Priority Mail was also a major consideration. Tr. 6/2548 ("Western network was reconfigured . . . to maintain service for Express Mail and . . . **to provide improved service for Priority Mail**") (emphasis added).¹⁶ And Professor Bradley confirmed that "more capacity exists than is required to handle just the Express Mail." USPS-T-22 at 38, n.28.

Perhaps most telling, Mr. Pickett acknowledged that the Eagle network is very similar to the network as it existed in 1990. Tr. 43/18535. He also acknowledged that the percentage of Express Mail on that network is virtually the same now as it was in Docket No. R90-1. Tr. 43/18561. Significantly, under those facts the Commission made an explicit determination to distribute the network premium to Priority Mail as well as to Express Mail. *Id.*; *Postal Rate & Fee Changes, 1990*, Docket No. R90-1, Opinion and Recommended Decision at 1/III-182 to III-193, ¶¶ 3692-3716. It explicitly reaffirmed that determination in Docket No. R94-1. *Postal Rate & Fee Changes, 1994*, Docket No. R94-1, Opinion and Recommended Decision at 1/III-49 to III-50, ¶¶ 3164-67. The facts applicable to the Western network establish even more compellingly that Priority Mail should bear its fair share of the premium for that network as well.

16. Whether or not this particular discussion was followed by immediate action, Tr. 43/18537-38, it demonstrates that once action was taken, that action was based on a desire to improve service for Priority Mail as well as for Express Mail.

Imposing the entire network premium on Express Mail users alone is patently unfair. As Dr. Neels recommended, the Commission should return to its consistent pre-Docket No. R97-1 approach and attribute the dedicated air network premium both to Express Mail and to Priority Mail. Tr. 32/16004. This results in a 60% decrease in the domestic air costs attributed to Express Mail and a 13% increase in the domestic air costs attributed to Priority Mail. *Id.*

C. The Distribution Of The Cost Of Empty Space In Purchased Highway Transportation Should Be Revised To Allocate Those Costs To The Classes Of Mail That Generate The Need For The Purchased Capacity.

The Postal Service's allocation of the cost of empty space in purchased highway transportation is determined by the mix of all mail unloaded from trucks as sampled in TRACS. Dr. Neels develops an improved distribution method. Tr. 32/16011-19. His approach gives more weight to those subclasses that are on the more highly utilized trips, and which therefore are more likely the driving force in determining the total capacity purchased by the Postal Service. Tr. 32/16011.

Giving greater weight in the distribution process to the types of mail that travel on the more fully loaded trucks more closely aligns costs with the classes of mail that give rise to those costs. Tr. 32/16011-12. Under Dr. Neels' approach, the costs of occupied space are still distributed to the mail which occupies that space, while the cost of empty space is distributed to a mix of mail that better represents the "capacity-causing mail mix." *Id.*

Dr. Neels' alternative method increases the Base Year purchased transportation costs distributed to First Class Mail (by 3.78%), Priority Mail (by 7.33%), and Parcel

Post (by 2.37%). Tr. 32/16016. The costs assigned to Periodicals, Standard Mail (A), Express Mail, and non-Parcel Post Standard Mail (B) decline. *Id.*

The fact that Priority Mail's share goes up the most is appropriate. The TRACS sampling system has a number of flaws which, while not quantifiable on this record, likely result in undersampling Priority Mail. Tr. 32/16019-25. For example, the TRACS sample excludes "emergency" contracts and "exceptional service" highway movements. The costs of these two types of movements are substantial; together they comprise almost 16% of total purchased highway transportation costs. Tr. 32/16020. The evidence on the nature of these movements suggests that, on average, emergency contract and exceptional service movements are likely to contain higher proportions of time-sensitive mail than do regular movements. Tr. 32/16021. Thus, if these mail movements were sampled in TRACS, the TRACS distribution keys would likely reflect a greater volume of Priority Mail than is now recorded, resulting in higher Priority Mail attributable costs. *Id.*

UPS submits that Dr. Neels' approach is the best on this record. In his rebuttal testimony, Postal Service witness Bradley recognized Dr. Neels' "legitimate issue that the current Postal Service method of expanding empty space may be biased because it does not account for the possibility that some of the responsibility for the empty space may not lie with the mail on the truck when it is observed." Tr. 43/18440. However, Dr. Bradley has proposed a "compromise" modification to Dr. Neels' specific distribution method.

Given the data currently available, no single distribution method can match perfectly the mail which generates the need for the total capacity purchased with the

cost of the resulting empty space. While Dr. Neels' approach does a better job than does the present distribution method, Dr. Bradley's "compromise" also represents an improvement over the current approach.¹⁷ As Dr. Bradley states, "the compromise method starts with the UPS method but replaces the 'more fully loaded trucks' distribution key with one based upon all of the segments, including the one on which the empty space occurs." Tr. 43/18444. See also Tr. 43/18447, Table 13.

The Commission should adopt Dr. Neels' allocations. At the very least, it should adopt one of the two new proposed methods.

D. Elemental Load Costs Should Be Distributed Among The Classes And Subclasses Of Mail On The Basis Of Weight.

The Postal Service's use of pieces to distribute attributable elemental load costs does not accurately trace costs to the mail that causes them.

Elemental load time is the time carriers spend handling mail at the point of delivery. Postal Service witness Daniel testified that the cost of delivering parcels is affected by shape, and that distributing those costs by weight helps to capture that effect. USPS-T-28 at 3. In providing guidance for the Postal Service's rate design witnesses for First Class Mail and Standard Mail (A), Ms. Daniel distributed those costs by weight within the narrow ounce increments in those subclasses. USPS-T-28 at 10-17. Nevertheless, the Postal Service does not use weight to distribute elemental load

17. Dr. Bradley's method involves the joint determination of capacity and empty space across the entire purchased highway transportation network and distribution keys that moderate the effects of the two different assumptions embodied in the Postal Service's current method and in Dr. Neels' method. Tr. 43/18443.

costs among subclasses in recognition of the much greater weight differences that exist among the parcel-shaped classes of mail.

Ms. Daniel and Mr. Luciani testified that the cost of delivery is more for heavier parcels than for lower weight parcels. USPS-T-28 at 3, 8-9; Tr. 25/11780. Whether or not Ms. Daniel did a "study," see Tr. 25/11991-11997, weight clearly has an impact on the time it takes to handle mail at the delivery point.

Postal Service data introduced into the record after Ms. Daniel and Mr. Luciani testified shows clearly that it takes longer and therefore costs more to deliver heavier parcels than lighter parcels. In particular, Postal Service witness Baron provided the results of a regression analysis which demonstrates that large parcels take significantly longer to load -- about 14 seconds more, on average -- than do small parcels. Tr. 39/17837-38.

That is especially so when comparing the cost of delivering under one pound parcels moved as Standard Mail (A) with the cost of delivering the far heavier parcels moved as Parcel Post. While there are undoubtedly exceptions, see Tr. 38/17260-62, on average heavier parcels have greater cube than lighter parcels, and parcels of greater cube weigh more than smaller parcels. As Amazon.com witness Haldi acknowledged, there "is an established relationship" between cube and weight. Tr. 45/19563. He could not do otherwise: Postal Service witness Eggleston demonstrates

the clear and unmistakable relationship between cube and weight in her testimony.

See USPS-T-26, Attachment K, "Summary of Cube-Weight Relationship Results."¹⁸

Can there be any question that most Standard Mail (A) parcels probably fit in a mailbox, while most Parcel Post parcels must be delivered at the door -- a much more time-consuming process? See Tr. 39/17837-39. Likewise, if weight is a proper basis for reflecting delivery cost differences within the narrow weight ranges from one ounce up to thirteen ounces for First Class Mail Presort and from one ounce up to sixteen ounces for Standard Mail (A), then it surely is a proper basis for reflecting the more significant weight differences between under one pound Standard Mail (A) parcels and the far heavier Parcel Post pieces. The Commission should not ignore these basic facts when it distributes elemental load costs.

UPS witness Luciani has developed a distribution key based on average weight and volume data for each subclass. The results of his analysis are presented in Table 3 of his testimony. Tr. 25/11782. They should be adopted by the Commission.¹⁹

E. The Cost Of Sequencing Parcels At The Dock Should Be Distributed To Parcels.

The significant time spent by city carriers at the dock individually removing each of the 30 or so parcels handled each day from the carrier's parcel hamper, examining the address, and placing the parcel in a specific sequence in the carrier's vehicle is not

18. Postal Service witness Bozzo also noted in another context that "shape conveys information on weight" Tr. 44/19468.

19. Mr. Luciani's distribution key distributes attributable elemental load costs at the class/subclass level, not within subclasses.

captured in IOCS.²⁰ These costs are buried in the broad category of Street Support costs. Tr. 25/11783. Street Support costs are allocated as a piggyback off of the distribution of the city carrier costs for load time, access time, route time, and office costs. Tr. 25/11784. Therefore, the costs incurred by the city carrier at the dock in sorting and loading parcels into the delivery vehicle are distributed to all types of mail, not just to parcels. Tr. 25/11784.

The Postal Service's Engineered Standards study provides an estimate of the time spent to remove a parcel from a hamper, look at the address, and place the parcel in an appropriate spot in the vehicle. In rebuttal testimony, Postal Service witnesses Raymond and Kay argued that the Engineered Standards study recommendations have not yet been implemented, that parcels currently are not *fully* sequenced when they are loaded into the carrier's vehicle at the dock, and that therefore the estimates in the Engineered Standards study should not be used. Tr. 39/17764-67, 17923. Ms. Kay also argued that there is no written requirement on how parcels are to be loaded into vehicles. Tr. 39/17766.

However, on cross-examination Ms. Kay agreed that there are specific and explicit written requirements for Special Purpose Routes which instruct city carriers to sequence parcels in delivery order when loading their vehicles. Tr. 39/17825-26.

20. Amazon.com witness Clark asserted that there are only about five parcels per carrier route in comparison to the 30 estimated by Mr. Luciani. Tr. 41/18138. However, Mr. Clark's calculation included only Parcel Post parcels and excluded the parcels in Priority Mail, Bound Printed Matter, and other subclasses. Response of Amazon.com, Inc. witness John Clark to Question Raised at Hearings on August 25, 2000 (filed August 30, 2000).

These procedures suggest that it makes good delivery sense to sequence parcels when loading them into the vehicle rather than while en route. Carriers likely follow that procedure for all types of routes. At the very least, those procedures indicate that the delivery employee needs to be aware in advance which addresses are receiving one of the 30 or so parcels that a city delivery carrier delivers on an average day; otherwise, there would be a significant amount of time spent on the route back-tracking and going to the back of the truck "just to check" whether there is a parcel to be delivered.

While the Engineered Standards study's specific time estimate for parcel handling and loading at the dock may represent an "ideal" time, surely it provides a better approximation of those costs than does the broad Street Support piggyback factor, based as it is on all sorts of other activities.

Ms. Kay also argues that the volume variability of parcel handling and loading at the dock is more similar to that for load time (*i.e.*, the time spent by the carrier placing mail in the customer's mailbox or handing mail to the customer) than to that for in-office sorting. Tr. 39/17766. However, cross-examination made clear that "load" time and the time spent "loading" the carrier's vehicle at the dock are entirely different operations. Tr. 39/17830-31.

Mr. Luciani's adoption of the volume variability of in-office sorting costs to estimate the variability of parcel sequencing at the office dock is much more reasonable than Ms. Kay's analogy. Like in-office sorting, each individual parcel must be picked up, examined, and then placed in an appropriate location in the vehicle. Tr. 25/11783-84.

Accordingly, the Commission should adopt the estimated parcel handling and loading costs at the dock developed in the Engineered Standards study and apply to that estimate the volume variability of in-office costs to determine the cost of sequencing parcels at the dock, allocate those costs to the subclasses based on the CCCS parcel count, and, to avoid a double-count, remove those same costs from Street Support costs. Tr. 25/11784-85.

F. The Costs Of Exclusive Parcel Post And Of Parcel Post Combination Routes Should Be Attributed To The Classes Of Mail Delivered On Those Routes.

The evidence indicates that the Postal Service has failed to attribute sufficient City Carrier Special Purpose Route costs to parcels. City Carrier Special Purpose Routes include Exclusive Parcel Post Routes, Parcel Post Combination Routes, Collection Routes, Non-Parcel Combination Routes, and Relay Routes. The costs of these routes are combined and distributed based on a study performed by Postal Service witness Nelson in Docket No. R97-1. Tr. 6/2643-46. Data made available in this docket suggests that this ignores the predominance of parcel mail on Exclusive Parcel Post Routes and Parcel Post Combination Routes.²¹

In her rebuttal testimony, Postal Service witness Kay presented data on the distribution of pieces delivered on the different types of Special Purpose Routes,

21. Although it is not possible to tell what the Postal Service's distribution key is for each individual type of Special Purpose Route, Tr. 6/2663-65, across all of the SPR route types the Postal Service distributes only \$11 million to Parcel Post. Tr. 25/11786. On the other hand, the cost of Exclusive Parcel Post Routes and of Combination Parcel Post Routes is \$133.8 million.

including separate figures for Exclusive Parcel Post Routes and for Parcel Post Combination Routes. Tr. 39/17768-70.²² This data indicates that while the majority of the volume delivered on Exclusive Parcel Post and Combination Parcel Post routes is not Parcel Post, the majority of that volume does consist of parcels, especially Priority Mail and Standard Mail (B). Tr. 39/17770.

The Commission should, as UPS witness Luciani suggested in his interrogatory responses (Tr. 25/11870-71), make use of this new data to distribute the costs of Exclusive Parcel Post Routes and Parcel Post Combination Routes separately from Special Purpose Routes as a whole. This is more appropriate than the Postal Service's aggregated approach.

G. The Postal Service's Parcel Post Final Adjustments Should Be Adjusted.

The Postal Service proposes a "final adjustment" that reduces Parcel Post Test Year transportation costs by \$10 million before rates and \$21 million after rates. Tr. 25/11777-78. In computing this adjustment, the Postal Service assumes that there were no DSCF-entry or DDU-entry parcels in the 1998 Base Year, but that there will be a significant amount "post-mix," *i.e.*, in the Test Year, due to the introduction of the DSCF-entry and DDU-entry rate discounts in 1999. Tr. 25/11777-80.

22. Ms. Kay's data presentation was prompted by UPS testimony suggesting that, under the information then available, Exclusive Parcel Post Routes were devoted exclusively to the delivery of Parcel Post, so that the full cost of those routes should be attributed to Parcel Post. See Tr. 25/11785-87. Of course, new information often should and sometimes does lead to new proposals, as this instance shows.

However, Postal Service witness Eggleston's Parcel Post transportation analysis is based on an estimate that 7.11% of DBMC parcels were entered at the DSCF in 1998 (*i.e.*, "pre-mix"). Tr. 25/11778, 41/18179. That estimate is from a survey used by Postal Service witness Mayes in Docket No. R97-1, which indicated how much DSCF entry was already taking place in the absence of any rate discounts. Tr. 25/11927, 41/18178.

To be consistent with Ms. Eggleston's transportation analysis, the Parcel Post "final adjustment" should also use this same estimate. To do otherwise would result in double counting the cost savings from DSCF-entry and DDU-entry parcels. Tr. 25/11861.

Ms. Eggleston suggests in her rebuttal testimony that the 7.11% estimate should be changed to zero. Tr. 41/18161-63. However, some parcels clearly were entered at DSCFs in 1998. The only available data is Ms. Mayes' Docket No. R97-1 estimate of 7.11%. Tr. 25/11927, 41/18178. The Commission should use that estimate as the best available information in calculating the Parcel Post transportation final adjustment, thereby reducing the final adjustment by \$6.6 to \$7.7 million. Tr. 25/11780.

IV. COST COVERAGES FOR THE COMPETITIVE CLASSES OF MAIL SHOULD BE INCREASED.

As we have shown, the primary purpose for creating the Commission was to make sure that the Postal Service would not succumb to the inevitable temptation to take advantage of its monopoly power by imposing the "lion's share" of costs on the "ordinary mailer." Senate Report at 3, 13. This overriding principle has significant implications for the proper interpretation and application of the Act's ratemaking criteria.

In particular, it indicates that the ratemaking factors -- and especially Section 3622(b)(5) on readily available alternatives -- should be interpreted to protect captive users and ensure that those who cannot easily protect themselves from postal rate increases are protected by the Commission, while mailers who are able to protect themselves by moving to alternative suppliers do not need as much protection.

The Postal Service's proposed cost coverages would achieve the exact opposite result.

A. Priority Mail's Cost Coverage Should Be At Least As High As That For First Class Mail.

Priority Mail does a job that First Class Mail cannot do and is not asked to do -- deliver letters, flats, and parcels from under one pound to 70 pounds, in an infinite variety of shapes and sizes, to every address in the country with (as we show below) speed equal to or, in most cases, better than First Class Mail. The fact that Priority Mail performs this job -- a task much more difficult than First Class Mail's delivery of nearly uniform pieces -- in many more ZIP codes in Priority Mail's two-day service area speaks volumes about Priority Mail's true performance and value of service.

As Dr. Sappington showed, the criteria specified in § 3622(b) of the Act mandate a Priority Mail cost coverage that is higher than First Class Mail's cost coverage. However, in light of the substantial rate increase that would entail, Dr. Sappington recommended that Priority Mail's cost coverage *in this case* be moderated so that Priority Mail's markup ratio would be the same as the ratio proposed by the Postal Service for First Class Mail; that results in a Priority Mail cost coverage of 176%. Tr. 31/15239.

1. Priority Mail Is a High Value Service.

Section 3622(b)(2) requires the Commission to consider “the value of the mail service actually provided each class or type of mail service to both the sender and the recipient, including but not limited to the collection, mode of transportation, and priority of delivery.” 39 U.S.C. § 3622(b)(2). The section’s specific reference to “collection, mode of transportation, and priority of delivery” suggests a focus on what has come to be referred to as the “intrinsic value of service” of a class of mail.

The Postal Service places considerable emphasis on the “economic value of service” concept, *i.e.*, the own-price elasticity of demand for the service. Own-price elasticity is an estimate of “the degree to which usage of the service declines in response to price increases.” USPS-T-32 at 5 (Mayes).

As Dr. Sappington explained, the Commission should not place undue reliance on this very imperfect measure of value. Tr. 31/15229-33. Dr. Sappington pointed out that “demand is influenced by many factors other than price,” Tr. 31/15230, and that “even if the demand for a service declines substantially as its price increases, customers may value the service highly.” Tr. 31/15230. *See also* Tr. 31/15427 (“[a] higher own-price elasticity can be associated with either a higher or a lower value of service . . .”).

Using own-price elasticity to measure value of service also introduces circularity into the ratesetting process. The existing price for a product affects its measured own-

price elasticity and thus its alleged “value of service,” rather than having the product’s value of service determine the appropriate price, as 39 U.S.C. § 3622(b)(2) directs.²³

While own-price elasticity is certainly relevant to the Commission’s considerations, it is best considered under criterion (b)(5) of the Act, *i.e.*, the existence of readily available alternatives, as a measure of the competitiveness of the market in which a product is provided. Tr. 31/15230. A high own-price elasticity generally indicates that customers have readily available alternatives and thus require less protection from the Commission.

Dr. Sappington also illustrated the danger of over-reliance on a product’s “incremental” value of service, *i.e.*, comparisons of service quality with that provided by other providers in the market. Tr. 31/15229-33. Such reliance can easily result in protecting the Postal Service from effective competition. Tr. 31/15231.

Nevertheless, Priority Mail generally provides good value when compared to its competitors. It is universally accessible and offers features that alternative private services either do not provide, or provide only at a substantial extra charge. These services include Saturday delivery at no extra charge and free delivery on Sunday during peak delivery seasons. Tr. 31/15368. And Priority Mail does so **at a fraction of the price** charged by its competitors. As Dr. Haldi points out, even taking into account the Postal Service’s proposed 15% rate increase, Priority Mail will continue to have a

23. Using own-price elasticity to measure value of service runs the risk of inadvertently lapsing into Ramsey pricing. Tr. 31/15232-33. The Commission has repeatedly rejected Ramsey pricing. *Postal Rate & Fee Changes, 1987*, Docket No. R87-1, Opinion and Recommended Decision at 372.

substantial rate advantage over its private sector competitors. Tr. 25/11527-31. That this substantial rate advantage together with Priority Mail's service features provide a high value of service is evident from its dominant share of the market, Tr. 31/15245 (a subject we will discuss in more detail later, at pages 55-56, *infra*).

More important, Section 3622(b)(2) primarily contemplates a comparison of Priority Mail's service features with the features of other Postal Service products. Tr. 31/15253-54. Here, Priority Mail truly shines.

Relevant features in this regard include speed of delivery and the convenience and security that a service provides. Other measures include features that are provided automatically (such as Saturday delivery), or that can be purchased as desired (such as the availability of pick-up service and options like Delivery Confirmation). As Dr. Sappington concluded, "Priority Mail fares well on these direct measures of service quality." Tr. 31/15252.

Like First Class Mail, Priority Mail is sealed against inspection. Tr. 31/15252. The convenience of the Postal Service's widespread collection system is available to a large portion of Priority Mail, *i.e.*, those pieces that weigh less than one pound. *Id.* That was nearly 39% of Priority Mail's volume in FY1999. Tr. 31/15253. Priority Mail pieces that weigh more than a pound may also use the collection system if postage is paid by meter imprint. *Domestic Mail Manual*, Issue 55, § D100(2.3) (January 10, 2000).

Priority Mail also offers pickup service for an additional fee, whereas First Class Mail users cannot purchase pickup service at any price. Tr. 31/15253. Electronic Delivery Confirmation is available to large Priority Mail users at no extra charge and

other Priority Mail users can purchase manual Delivery Confirmation service, while First Class Mail users cannot even purchase Delivery Confirmation service. *Id.* And the Postal Service supplies free packaging materials to its Priority Mail customers. *Id.*

As compared to First Class Mail, Priority Mail also benefits from (1) unique mail processing resources; (2) earlier clearance times than First Class Mail; (3) less reliance on surface transportation; (4) priority on the Eagle Network; and (5) supplemental Sunday routes. Tr. 7/2724-25, 31/15253-54.

Customer behavior is probably the most reliable indication of Priority Mail's high level of service. Priority Mail's volume growth has been extremely healthy. Tr. 31/15244. Furthermore, "If customers repeatedly choose a more expensive mail service when a less expensive service is available, their choice provides strong evidence that they value the more expensive service more highly." Tr. 31/15254. As Dr. Sappington testified,

"In 1996, more than 136 million pieces were sent as Priority Mail, even though these pieces could have been sent more cheaply as First Class Mail. By 1999, the number of such pieces sent by Priority Mail had grown to more than 215 million. These numbers suggest that many customers value Priority Mail more highly than they do First Class Mail."

Tr. 31/15254 (footnotes omitted). This indicates a high value of service for Priority Mail as compared to First Class Mail. As noted above and as will be discussed in more detail later, Priority Mail's dominant market position also evidences its high value of service as compared to its competitors.

The arguments made by APMU, an association of large users of Priority Mail whose interests obviously lie in depressing Priority Mail rates, cannot overcome these facts, as we now show.

2. Priority Mail Provides Faster Service than Does First Class Mail.

Through the often confusing and apparently contradictory testimony in this record about Priority Mail and First Class Mail service performance, one thing is clear -- the evidence strongly indicates that Priority Mail is delivered **faster** than First Class Mail most of the time.

Priority Mail's superior speed of delivery becomes apparent once one recognizes (1) the vastly greater extent of Priority Mail's two day service area, and (2) the greater challenges that Priority Mail faces as a result of the type of mail it carries.

Even identical delivery standards between identical ZIP code pairs can present greater challenges to Priority Mail than to First Class Mail because of differences in their mail mixes. Certain types of mail are just more difficult and more time-consuming to process and deliver than are others: "In 1999, First Class letters achieved their service commitments 90.2% of the time; in contrast, First Class flats achieved their service commitments only 78.5% of the time." Tr. 31/15251.

Priority Mail includes flats, parcels, and irregular pieces that weigh up to 70 pounds; First Class Mail, on the other hand, consists predominantly of letters, which are lighter and less bulky than flats, parcels, and irregular pieces. Indeed,

"Flats, parcels, and irregular pieces and parcels accounted for more than 99% of Priority Mail volume in PFY1998. Less than 1% of Priority Mail

volume was letters. In contrast, letters accounted for more than 88% of First Class Mail volume in PFY1998.”

Tr. 31/15250 n.32. When First Class Mail's service performance record is matched against that of Priority Mail for items of the same type, First Class Mail achieves its service standard *less frequently* than does Priority Mail. Tr. 31/15251 n.34, 15320-21.

Moreover, Priority Mail's two day service standard covers ***more than 90% of all possible ZIP Code combinations***; for First Class Mail, the corresponding figure is ***less than 20%***. See Tr. 31/15249. There are more than 600,000 ZIP code pairs where Priority Mail has a two day service standard while First Class Mail's service standard is greater than two days. Tr. 31/15249. That represents approximately 73% of all possible ZIP Code combinations.²⁴ Even if performance against standard may be somewhat less for Priority Mail and the harder-to-handle items it carries, can there be any doubt that in most instances, Priority Mail gets there faster than does First Class Mail?

Another revealing indication that Priority Mail is at least as fast as First Class Mail and usually faster is to compare the percentage of First Class Mail that is delivered on time and the percentage of Priority Mail that is delivered no more than one day late. The data reveal that in 1999, 85% of First Class Mail with a three day standard was delivered in three days or less, while 93% of Priority Mail with a two day standard was

24. Using the data at Tr. 31/15249 (Table 5): $780,514 - 157,081 = 623,433$ ZIP Code pairs where Priority Mail but not First Class Mail has a two day delivery standard; $623,433 \div 848,862$ (total number of ZIP Code pairs, i.e., $8,786 + 780,514 + 59,562$) = 73.4%.

delivered in three days or less. Tr. 46/20706, 20707. A similar advantage for Priority Mail existed in 1998, when 81% of First Class Mail with a three day standard was delivered in three days or less while 90% of Priority Mail with a two day standard was delivered in three days or less. *Id.*²⁵

APMU harps on service performance statistics in the overnight service area. That area comprises an almost insignificant number of ZIP code pairs: approximately 1% of all ZIP Code pairs. Tr. 31/15249. In any event, the fraction of Priority Mail that is delivered no more than one day late is nearly the same as the fraction of First Class Mail that is delivered no more than one day late. Tr. 46/20706, 20707.

Data regarding the "tail" of the distribution of delivery performance also shows that Priority Mail provides service as fast as or faster than First Class Mail.²⁶ The portion of First Class Mail delivered more than three days beyond its service standard is higher than that for Priority Mail. Tr. 46/20703, 20705. The portion of First Class Mail delivered more than four days beyond its service standard is also higher than that for Priority Mail. *Id.*

25. These comparisons do not take into account the different compositions of Priority Mail and First Class Mail. As noted above, since Priority Mail consists almost exclusively of flats and parcels while First Class Mail primarily carries letters, it is more difficult for Priority Mail to achieve any specified service standard.

26. The "tail" of the distribution measures how late beyond the service standard late mail pieces are delivered. Dr. Haldi testified on cross-examination on his original APMU testimony that data on performance in the "tail" was not available. Tr. 25/11763, 11765-66. However, such information was provided in response to an APMU interrogatory on May 5, 2000, a full 17 days before his direct testimony was filed and two months before he was cross-examined. See Tr. 46/20705-07.

Priority Mail's performance has improved systematically since the PMPC network became fully operational. Tr. 25/11695-700. Priority Mail's FY1998 performance is likely an aberration, since the PMPC network was being phased in during 1998 and did not become fully operational until July, 1998, about ten months into the fiscal year.

Priority Mail's speed advantage is also shown by the predominant portion of Priority Mail volume that goes to its vastly larger two day service area as compared to the proportion of First Class Mail that goes to its much smaller two day service area. In 1999, the volume of Priority Mail sent to destinations with a two day service standard was more than five times the volume of Priority Mail sent to destinations with a one day service standard. Tr. 46/20970. ODIS data place this ratio at approximately 3.5 to 1.0. Tr. 21/8564. On the other hand, First Class Mail is sent primarily within its overnight service area. Tr. 46/20978. Clearly, mailers use Priority Mail for longer distance mailings.²⁷

While APMU seeks to disparage the service provided by Priority Mail compared to that offered by its competitors and by First Class Mail, one must wonder why APMU's members continue to use Priority Mail at all. The answer is clear: Priority Mail provides speedy delivery and other attractive service features at prices far below those charged by its competitors. That is an extremely good value proposition.

27. The best evidence on this issue would be average length of haul data; unfortunately, such data is not available. Tr. 21/9374.

3. Dr. Sappington's Proposed Cost Coverage Promotes Fair Competition.

Criterion (b)(4) of the Act requires that the Commission consider "the effect of rate increases upon . . . enterprises in the private sector of the economy engaged in the delivery of mail matter other than letters." 39 U.S.C. § 3622(b)(4).²⁸ Criterion (b)(5) directs the Commission to consider "the available alternative means of sending and receiving letters and other mail matter at reasonable costs." *Id.*, § 3622(b)(5). These factors are intended *inter alia* to protect against unfair postal competition. *NAGCP*, 462 U.S. at 829 n.24. They are intended to protect competition rather than a particular competitor (such as the Postal Service).

The Postal Service has many competitive advantages. Its ability to spread the institutional portion of the costs of its ubiquitous delivery network over both competitive services and the huge volume of mail carried in its monopoly services gives the Postal Service a significant advantage over its competitors. Tr. 31/15441. The Postal Service also has a number of artificial advantages as a result of its status as a government agency. For example, the Postal Service does not pay property taxes; it does not pay motor vehicle license and registration fees; and it can borrow funds from the Treasury at favorable rates. Tr. 31/15440. As Dr. Sappington testified, these artificial cost advantages could enable the Postal Service to drive more efficient producers from the

28. Criterion (b)(4) also requires the Commission to consider the impact of rate increases on users. Dr. Sappington did so when he mitigated Priority Mail's cost coverage. Tr. 31/15258-59. Of course, in the case of Priority Mail, users have alternatives available to them, so that they can protect themselves against the impact of postal rate increases.

market even when postal rates exceed attributable costs; the Commission should therefore “ensure that each service for which the Postal Service faces competition bears a meaningful portion of institutional costs.” Tr. 31/15235 n.14.

APMU has urged the Commission to recommend reduced rates for Priority Mail in order to preserve or increase the Postal Service’s market share. Yet, its own witness admitted that market share is not one of the statutory ratemaking factors. Tr. 25/11729. As a particular competitor, the Postal Service is no more deserving of special treatment than any other enterprise in the market. APMU’s arguments designed to increase or protect the Postal Service’s market share -- which are actually designed to reduce the rates APMU’s members pay -- run counter to the Act and the purpose for which the Commission was created.

In setting cost coverages for competitive classes of mail, the Commission should take into account the fact that there are undoubtedly a number of costs that are *attributable* to, but that will not be *attributed* to, those services. We have already discussed the deficiencies of the Postal Service’s “method” of attributing advertising costs, for example. Several other categories of such costs have also been identified in this docket. For example, the Postal Service has arrangements with certain Mail Boxes, Etc. (“MBE”) outlets, under which the Postal Service pays the MBE operator 20% of the Priority Mail (and of the Express Mail) revenue generated by the outlet. Tr. 46/21797. See also Tr. 7/2767-68.

Some of these “unattributed but attributable” costs may not be able to be quantified on this record. See, e.g., Tr. 32/16019-25 (describing the likelihood that TRACS does not adequately distribute purchased transportation costs to time sensitive

mail). The inability to quantify these costs because of insufficient data should be taken into account in setting Priority Mail's cost coverage.

A particularly significant example is evident from the recent decision by the United States Court of Federal Claims in the PMPC contract dispute between Emery and the Postal Service. *Emery Worldwide Airlines, Inc. v. United States*, Docket No. 00-173C, United States Court of Federal Claims, *decision filed* August 25, 2000. As a result of that decision, the Postal Service will be required to make substantial additional payments to Emery under the PMPC contract. These costs are clearly attributable to Priority Mail, but they will undoubtedly not be reflected in the costs actually attributed to Priority Mail in this case.²⁹ The Commission should adopt a substantial cost coverage for Priority Mail to ensure that Priority Mail users, and not primarily First Class Mail users, will absorb these costs and still make a contribution to institutional costs commensurate with Priority Mail's high value of service.

The evidence suggests that Priority Mail should have a cost coverage higher than that for First Class Mail, as it had historically. Thus, the cost coverage recommended by Dr. Sappington is actually a lower bound, since it merely equals that for First Class mail. It should be adopted.

29. The Postal Service objected to UPS interrogatory UPS/USPS-T34-4, which requested information about Emery's "unbilled revenue" of \$123.7 million under the PMPC contract. Objection of United States Postal Service to UPS Interrogatories UPS/USPS-T34-3(e) and 4 to Witness Robinson (filed February 25, 2000). Some of Emery's outstanding claims under the contract are listed at Tr. 7/2734.

4. Priority Mail Is the Dominant Provider in the Market.

APMU's plea for a reduced cost coverage for Priority Mail is based largely on its claim that Priority Mail's market share is declining. Tr. 25/11538-40. That is a myth.

APMU's claim is based on fragmentary data from an uncertain source.³⁰ More complete data from an organization long relied on by the Postal Service shows that Priority Mail's market share as measured by pieces is on an upward trend. Tr. 45/19612-26. Its market share as measured by revenue is at least holding firm, if not increasing; its revenue market share was actually somewhat higher in 1999 than it was in 1994. Tr. 45/19626.

Priority Mail has grown from 518 million pieces to 1.279 billion pieces since 1990 – an average annual growth rate of about 10%. Tr. 31/15243-45. It dominates the two to three day delivery market. The latest data from The Colography Group, Inc. ("Colography") gives it a 70% market share of shipments – well more than twice the rest of the market combined. Tr. 45/19626. Indeed, Priority Mail's volume is more than 5 times greater than UPS's comparable volume, and Priority Mail's revenue is more than \$2 billion greater than that of UPS. Tr. 45/19630-31. No wonder Colography has only recently proclaimed that Priority Mail is "the undisputed shipment leader" in the market. Tr. 25/11731.

30. APMU presents market share figures based on pieces for five periods: 1990, 1993, 1997, 1998, and part of 1999. Likewise, APMU's revenue market share numbers cover only 1997, 1998, and part of 1999. Tr. 25/11539.

Clearly, Priority Mail is not a 98 pound weakling, as APMU would have the Commission believe. Priority Mail has been able to achieve what competing services can only dream of: the ability to deliver packages of all kinds to each and every household in the country in approximately 2 to 3 days at rates greatly below those of its competitors.

The Postal Service itself has a positive outlook for Priority Mail. "Dramatic growth in e-commerce will support . . . Priority Mail." USPS-LR-I-489, *Integrated Financial Plan FY 2000*, at 6. In fact, Priority Mail volume and revenue have consistently outperformed the Commission's estimates. See Tr. 25/11711-14. In FY2000, Priority Mail's volume is continuing to run ahead of projections. Tr. 35/16846. Its performance has led Colography to note "Priority Mail's growing influence in the marketplace" and its "expanding clout." Tr. 25/11731-32.

Under these circumstances, to assign competitive Priority Mail a cost coverage below that for First Class Mail would be directly contrary to the congressional purpose that motivated the creation of the Commission. Approximately 55% of Priority Mail is sent from one business to another. Tr. 9/3566-67. Only 12% of Priority Mail volume was sent by households in 1998, whereas almost 27% of First Class single piece letters were sent by households that same year. Tr. 9/3566-67, 3659-61. And approximately 55% of First Class letters were sent to or from households in 1998. Tr. 9/3659-61.

The recent performance of Priority Mail and its dominant market position allay any of the concerns raised in Docket No. R97-1 regarding the ability of Priority Mail to compete successfully in the marketplace. APMU's pleas to shift institutional costs away from Priority Mail (at the expense primarily of First Class Mail users) should be rejected.

**5. APMU's Priority Mail Dropship Discount Proposal
Should Also be Rejected.**

APMU proposes a dropship discount for Priority Mail without anything close to sufficient evidence for the Commission to evaluate its proposal. See Tr. 25/11560-61. Missing is credible information on actual cost savings, or any analysis of the impact of its proposal on other mailers and mail classes, as the Postal Service has amply demonstrated. Tr. 25/11633, 11634-35, 11637, 11647, 11650, 11651, 11652, 11653-55, 11659, 11666, 11668-69. Accordingly, the Commission should reject this proposal.

B. Parcel Post's Extraordinarily Low Cost Coverage Should Be Increased.

Professor Sappington recommends a cost coverage of 111% for Parcel Post. Tr. 31/15260. A cost coverage of 111%, while somewhat higher than that recommended in Docket No. R97-1 (108%), would still be among the lowest of all classes and would reduce the likelihood that Parcel Post revenues would fall below attributable costs. Tr. 31/15263-65.

As Dr. Sappington pointed out (Tr. 31/15261-63), Parcel Post's solid volume and revenue growth over the past decade "suggest[s] that Parcel Post can sustain a rate increase designed to ensure that its revenues exceed its attributable costs by a more healthy margin than . . . in R97-1." Tr. 31/15261. There is no doubt that Parcel Post's razor thin cost coverage has resulted in rates below attributable costs in the past. See Tr. 31/15264-65. Since attributable costs as presently measured typically understate incremental costs, Tr. 31/15237-39, there is an even greater likelihood that the available data understates the difference between Parcel Post costs and revenues.

Whether Parcel Post rates were below cost in eight out of the past ten years or only in two of those years, for example, makes little difference. The rates for any class of mail should never fall below attributable costs.

Moreover, the value of Parcel Post service has increased over the past few years. The availability of the new DDU dropshipment category improves Parcel Post's value of service by making Parcel Post "an integral component of even more expedited parcel services" (Tr. 31/15265), with delivery the next day 97% of the time. See Tr. 5/1912, 31/15265. See also Tr. 5/1874 (Postal Service instructions that Airborne@Home DDU shipments "will be delivered the next business day after receipt"). Similarly, Parcel Post users have the new Delivery Confirmation option available to use as much or as little as they wish. Tr. 31/15266, 15353. Even if a shipper elects to use that feature for only some portion of the shipper's parcels, the availability of the service adds value to Parcel Post, as does any option.

Dr. Sappington's cost coverage recommendation for Parcel Post together with Parcel Post's increased attributable costs result in a substantial rate increase. See Tr. 31/15260, 38/17249. However, Parcel Post's Test Year estimated unit attributable costs have risen sharply -- by 14.5% -- from the level estimated by the Commission in Docket No. R97-1. Tr. 31/15294. As a result, only a small increase in cost coverage is proposed.³¹

31. Postal Service witness Mayes proposes a Parcel Post cost coverage of 114% (over the Postal Service's understated measure of volume variable costs). USPS-T-32 at 40.

In sum, Parcel Post's relatively strong volume growth in the past few years (no matter how Parcel Post volume is estimated), recent improvements in its value of service, the fact that its users are not captive customers but rather have alternatives readily available to them, and the need to ensure fair postal competition in light of the many advantages the Postal Service has as a government agency all combine to support the minimal increase of three percentage points in Parcel Post's cost coverage to 111%, as recommended by Dr. Sappington.

1. Dr. Haldi's Criticism of Professor Sappington's Parcel Post Markup Is Flawed.

Amazon.com witness Haldi implies that Dr. Sappington is mistakenly "bas[ing] unit rate increases [for Parcel Post] on increases in total costs" alone. Tr. 44/19524. Dr. Haldi is just plain wrong.

Dr. Sappington emphasized that it was "not [his] testimony that the increase in total attributable costs is necessarily the 'most relevant cost measure' to employ when formulating rate recommendations." Tr. 31/15293. See also Tr. 31/15338 ("Percentage changes in rates need not 'track' percentage changes in total costs"). He specifically stated that he considered the 14.5% increase in Parcel Post's estimated unit attributable costs for the Test Year over the level estimated in Docket No. R97-1 in arriving at his cost coverage recommendation for Parcel Post. Tr. 31/15294.

Amazon.com seems merely to be attempting to distract attention from the simple and compelling logic that underlies Dr. Sappington's recommendation. The point is that to achieve the very modest 111% cost coverage that Dr. Sappington recommended, a substantial rate increase is required in large part because the costs of Parcel Post have

increased considerably, whether the increase is measured in terms of total costs, unit costs, or any other relevant measure. Tr. 31/15483-84.

Similarly, Dr. Haldi's statement that Professor Sappington's recommended Parcel Post rate increase would be "totally inappropriate" were the Commission to reject the Postal Service's proposed new methodology for estimating Parcel Post revenue and volume, Tr. 44/19526, is wrong. Dr. Sappington took into account both sets of volume and revenue estimates. See Tr. 31/15355.

Of course, if Parcel Post volume and revenue are estimated using the Postal Service's ill-considered BRPW/DRPW methodology -- and, as we show below, that methodology should be rejected -- then clearly Parcel Post's even healthier volume and revenue growth can easily sustain a much higher cost coverage than the modest 111% recommended by Dr. Sappington. See Tr. 31/15458. See also Tr. 11/4554-55.

Dr. Haldi makes the easily-asserted and oft-repeated claim that a substantial rate increase for Parcel Post "would reduce Parcel Post volumes and market share by an unacceptably large amount, to an unacceptably low level." Tr. 44/19526. However, as we have already noted, he admitted on cross-examination that protection of the Postal Service's market share is not among the statutory ratemaking factors. Tr. 25/11729.³²

In any event, Dr. Haldi makes an invalid market share comparison. He compares the alleged market shares of Parcel Post and UPS Ground Service, which are not comparable. The UPS volume includes under one pound parcels which the

32. Regardless of the market share which results, each mail subclass must nevertheless generate revenues sufficient to cover its attributable costs plus some reasonable share of institutional costs. 39 U.S.C. § 3622(b)(3).

Postal Service carries in Standard Mail (A), as well as books and similar materials which the Postal Service carries in the non-Parcel Post subclasses of Standard Mail (B). Tr. 29/14169-14171. To be valid, the comparison should include not just Parcel Post, but all of the ground parcels handled by the Postal Service. When that is done, the Postal Service's market share increases dramatically and UPS's share decreases dramatically. See Tr. 29/14165-79.³³ Indeed, the Postal Service's total package volume exceeds that of UPS, and its total package and expedited document delivery volume also exceeds that of UPS. See Tr. 9/3651.

Significantly, Postal Service witness Tolley testified that Parcel Post's market share has increased from 1992 to 1998 and that UPS's share of the ground parcel market has declined. USPS-T-6 at 158. Dr. Tolley also reported that "the Postal Service is gaining a relatively large share" of the parcel shipments that result from sales over the Internet. USPS-T-6 at 158.

Dr. Haldi criticized Dr. Sappington for relying on the increased value of service that the new DSCF and DDU dropship categories provide to Parcel Post. He suggested that Dr. Sappington views the DSCF and DDU rates through a "myopic lens." Tr. 44/19532. In fact, Dr. Haldi and Dr. Sappington both view these rates through the same lens -- as a charge for one component of a combined ground collection, transportation, and delivery product. See Tr. 44/19531. However, Dr. Haldi's vision

33. That is the case whether or not First Class Mail parcels are included in the comparison. The numbers in the record show that excluding First Class Mail parcels and using Dr. Tolley's numbers, the Postal Service's share of the ground parcel market would be 40% while that of UPS would be 50%. See Tr. 9/3651; 29/14165-73.

seems somewhat blurred or distorted, in that he fails to see that the option of combining one carrier's collection and transportation services with the Postal Service's ubiquitous delivery network increases the value of the combined product, including the Parcel Post portion, to the shipper. See Tr. 44/19531-35.

Dr. Haldi also criticized Professor Sappington's reliance on Postal Service witness Kingsley's testimony that 97% of the time, DDU Parcel Post is delivered the day after it arrives at the DDU, on the ground that Ms. Kingsley's information is anecdotal in nature. Tr. 44/19533. However, Dr. Haldi later concurred with Dr. Sappington's conclusion that "the Commission must make do with whatever imperfect information it has at its disposal." Tr. 44/19537. The inconsistency is striking.³⁴

Dr. Haldi appeared to suggest that because Parcel Post shippers who use Delivery Confirmation pay for it, the availability of the option to purchase Delivery Confirmation does not increase the value that Parcel Post delivers to its customers. Tr. 44/19534. That conclusion is incorrect. As Dr. Haldi grudgingly admitted on cross-examination, the availability of the option adds some value even for those who do not exercise the option. Tr. 44/19558. The "little" increase in value that Delivery Confirmation admittedly adds to Parcel Post (*id.*) together with the other factors relied

34. A number of Amazon.com's assertions are just flat out wrong. For example, its witness stated that "Witness Sappington fails to mention that none of the costs of Delivery Confirmation are included in the attributable costs of Parcel Post." Tr. 44/19534. On the contrary, Dr. Sappington clearly stated his recognition that the costs of providing Delivery Confirmation are not included in Parcel Post's attributable costs. Tr. 31/15296.

on by Dr. Sappington certainly support the “little” increase of three percentage points in Parcel Post’s cost coverage recommended by Dr. Sappington.

APMU also confuses *levels* of service with *changes* in levels of service. Tr. 44/19535. Dr. Sappington recommended a slight increase in the cost coverage for Parcel Post in part because the value of service provided by Parcel Post has increased *compared to what it was in Docket No. R97-1*. Tr. 31/15265-66. That is, his recommendation is based on a *change* in Parcel Post’s value of service compared to the service previously provided by Parcel Post. Dr. Sappington’s modest 111% cost coverage is consistent with Dr. Haldi’s assertion that Parcel Post provides low absolute value of service. Indeed, the recommended 111% cost coverage is among the lowest of all of the mail classes, including the much higher coverage of 133% the Postal Service recommends for Standard Mail (A), a deferred service. Tr. 44/19535; USPS-T-32 at 35.

Finally, Dr. Haldi pointed out that Professor Sappington acknowledges that “changes in the qualities of competitors’ services can affect the *incremental* value of service.” Tr. 44/19535-36 (emphasis added). However, Dr. Haldi failed to mention that Dr. Sappington warned against excessive reliance on incremental value of service because that can easily result in undue protection of the Postal Service from legitimate competition. Tr. 31/15423-26.

In the final analysis, Amazon.com’s basic approach is at odds with the statute. Under that approach, the rates for competitive products are depressed at the expense of higher rates for monopoly services. Tr. 25/11733. In other words, captive customers who have few or no alternatives to the Postal Service should be charged higher rates in

order to support lower rates for customers who have the ability to mitigate the impact of postal rate increases on them by choosing to use an alternative supplier. That is directly contrary to congressional intent. The Commission should decisively reject it.

2. Mr. Clark's Criticisms of Dr. Sappington's Proposed Parcel Post Markup Are Vague and Uninformed.

Amazon.com witness Clark contends that "Witness Sappington's conclusions concerning strong volume trends as showing Parcel Post can sustain a high rate increase completely ignores the effects of the UPS strike, which occurred at the end of 1997." Tr. 41/18132-33. This contention is misleading. Dr. Sappington's reliance on Parcel Post's strong volume growth is not restricted to the 1997 time period. Tr. 31/15261-63. As Dr. Sappington testified, Parcel Post's volume growth has been solid since 1990. Tr. 31/15262.

Furthermore, Mr. Clark agreed that the UPS strike ended before FY1999, and he acknowledged that Parcel Post volume nevertheless continued to grow in FY1998 and in FY1999. Tr. 41/18146-47. Parcel Post's volume growth over the past decade is particularly compelling in light of Postal Service witness Tolley's testimony that "between 1992 and 1998, ground parcel shipments did not increase appreciably." USPS-T-6 at 158.

Mr. Clark's testimony, while undoubtedly well-intentioned, is somewhat overstated. Compare Tr. 41/18127 (testimony that a decline in Parcel Post volume could have a "devastating long-range effect upon the survival of the Postal Service")

with Tr. 41/18143 (Parcel Post represents less than one-tenth of one percent of total postal volume and only 1 1/2% of total postal revenues).

There is little doubt that the modest 111% cost coverage recommended by Professor Sappington is more than justified under the criteria of Section 3622(b). The Commission should adopt it.

C. The Rate Increase For Express Mail Should Be Based On Revised Attributable Costs And The Postal Service's Proposed Cost Coverage.

The Postal Service proposes a cost coverage of 222% (over the Postal Service's measure of volume variable costs) for Express Mail. USPS-T-32 at 28 (Mayes).³⁵ This represents a long-overdue return to the levels in effect prior to Docket No. R87-1 and is more appropriate for the Postal Service's premium service offering than the extraordinarily low coverages that have recently been adopted for the class of mail that provides a level of service higher than any other mail class. See R97 Decision, Vol. 2, App. G, Schedule 3 (page 32 of 33), as revised 6/19/98.

Postal Service witness Mayes has demonstrated the high value of service Express Mail receives. USPS-T-32 at 29. While Ms. Mayes stated that Express Mail's high own-price elasticity "indicates an extremely low economic value of service," *id.*, Professor Sappington cogently explained the pitfalls of relying unduly on price elasticities as a measure of value of service. Tr. 31/15229-33.

35. The proposed coverage over the Postal Service's incremental cost estimate is 148%. USPS-T-32 at 29. This is below the Docket No. R87-1 coverage, but still considerably above the extremely low coverages of the last few rate cases. R97 Decision, Vol. 2, App. G, Schedule 3 (page 32 of 33), as revised 6/19/98.

Mr. Luciani calculated the rate increase required to cover Express Mail's attributable costs as properly calculated using the Postal Service's proposed markup ratio, normalized to the systemwide coverage. Tr. 25/11792 (13% using FY1998 data), Tr. 38/17249 (17% using FY1999 data). The Commission should adopt that rate increase in order to begin to restore Express Mail's cost coverage to a level that is more appropriate for the Postal Service's premium service offering.

V. THE POSTAL SERVICE HAS OVERSTATED PARCEL POST REVENUE, PIECES, AND WEIGHT.

A. The Postal Service's Almost Non-Existent Parcel Post Rate Increase Is Based Largely On Its Belated Adoption Of A New And Untested Method For Estimating Parcel Post Revenue, Pieces, And Weight That Should Be Rejected.

When it first issued its Cost and Revenue Analysis Report for FY1998, the Postal Service reported that the rates for Parcel Post were below Parcel Post's attributable costs. In fact, the Postal Service's figures showed that Parcel Post's FY1998 cost coverage was 96.6%. USPS-LR-I-2 at 1. Parcel Post's FY1998 volume was reported to be 266.5 million pieces, and its revenue was estimated at \$824 million. Tr. 2/735-37.

Well into FY1999, the Postal Service issued a revised Cost and Revenue Analysis Report for FY1998. All of a sudden, Parcel Post volume jumped to 316 million pieces -- a 19% increase -- and its revenue increased to \$948 million, a 15% increase. Its cost coverage skyrocketed from 96.6% to 112%. Cost and Revenue Analysis, Fiscal Year 1998, PRC Revised RPW Version (June 22, 1999) at 3.

What happened? The Postal Service implemented an after-the-fact change in the way it estimates Parcel Post revenue, pieces, and weight. Despite the dramatic

impact of the change, the Postal Service made no attempt in its original filing to explain away the substantial discrepancies between the results generated by the long-established approach and its new method.

The established methodology uses the DRPW sampling system to estimate Parcel Post's volume, revenue, and weight. The new approach relies on an ill-considered hybrid which combines information from the DRPW system with data taken from individual postage statements, entered into the Postal Service's PERMIT System database and then rolled up into its "BRPW" (Bulk Revenue, Pieces, and Weight) reports.

Not only is the hybrid DRPW/BRPW approach untested and unreliable, but the evidence shows that it indisputably and incorrectly counts as Parcel Post an unknown but potentially significant amount of volume and revenue that is really Standard Mail (A). Tr. 37/16957-58. The evidence also suggests a strong possibility that volume and revenue for other types of mail may be incorrectly counted as Parcel Post. And the hybrid system lacks sufficient accuracy checks to detect and correct such errors.

1. The BRPW-PERMIT System Incorrectly Counts an Unknown Portion of Standard Mail (A) Parcels as Standard Mail (B) Parcel Post.

There is no doubt that the PERMIT System data for Parcel Post, and therefore the Postal Service's BRPW volume and revenue estimates, overstates Parcel Post volume and revenue both in FY1998 and in FY1999. The Postal Service has admitted that in both of those years, an unknown amount of Standard (A) Single Piece Mail was counted as Parcel Post in the PERMIT System. Tr. 46/21526. *See also* Tr. 37/16999

(“it is really impossible to know how much -- how many pieces or any other variable you would care to use, of this Standard A have been recorded as Standard B Parcel Post in the PERMIT System”).

The volume of parcels involved is potentially significant: There were 150 million pieces of Standard (A) Single Piece Mail in 1998 and 42 million pieces in 1999. Tr. 46/20656.³⁶ The rates for many of these pieces were substantially higher than Parcel Post rates throughout all of FY1998 and for more than three months of FY1999 (including the peak Christmas season). Tr. 41/18091-97. Standard Mail (A) single piece rates were higher than Parcel Post rates for pieces weighing as little as nine ounces depending on zone, and for pieces weighing over thirteen ounces for all zones. Tr. 41/18092-97, 46/20656 (“Standard (A) Single Piece rates for all pieces over nine ounces (\$2.39 per piece to \$2.95 per piece) are in many instances greater than the applicable pre-R97-1 implementation Parcel Post rates”). As a result, mailers undoubtedly used the Parcel Post rates for those pieces.

The Postal Service has suggested that these under one pound pieces really are Parcel Post because the Postal Service allows them to pay the lower Parcel Post rates. Tr. 43/18804. That is clearly not so. The section of the Domestic Mail Classification Schedule (“DMCS”) which includes Parcel Post is entitled “Subclasses **Limited to** Mail Weighing 16 Ounces or More.” 39 C.F.R. § 3001, Subpart C, Appendix A, § 322 (emphasis added). The DMCS requires that Parcel Post pieces weigh sixteen ounces.

36. RPW reported a volume of 171 million pieces for Standard (A) Single Piece Mail in 1997. USPS-LR-I-117 at 6 (in evidence at Tr. 27/13006).

Tr. 37/16957. The Postal Service cannot change the DMCS by its own unilateral fiat.

Tr. 37/17000 (the Postal Service's new instructions to DRPW data collectors for FY1999 to count under one pound pieces as Parcel Post "have created a de facto classification change"). DMCS changes must be approved by the Commission and adopted by the Governors before they can become effective.

Furthermore, the Postal Service's own regulations acknowledge that the pieces in question are Standard Mail (A), not Parcel Post. The *Domestic Mail Manual* ("DMM") provision allowing these pieces to pay the lower Parcel Post rates explicitly states that they must meet all other standards for Standard Mail (A).³⁷ In determining whether mail is Parcel Post, "a key point is whether the piece weighs greater or less than 16 ounces."

Tr. 37/16993. The Postal Service's Handbook F-75, Section 3.10.4, which instructs DRPW data collectors on the proper classification of mail pieces, states that "With the exception of Library Mail and Special Mail, Standard Mail (B) weighs 16 ounces or

37. Issue 53 of the *DMM* (in effect for most of FY1998) states at page E-89, ¶ E620.1.1, in relevant part: "If the computed Single-Piece Standard Mail rate is higher than any Standard Mail (B) rate for which the mail could qualify *except for weight*, the lower Standard Mail (B) rate may be paid; all other standards for Single-Piece Standard Mail apply." See also *DMM* Issue 53, ¶ E612.4.6 at page E-85; *DMM* Issue 52 (in effect in the first few months of FY1998), ¶ 620.1.1, page E-89; *DMM* Issue 55 (currently in effect), ¶ E612.4.6, page E-91.

more”³⁸ There is no doubt that under the Postal Service’s own guidelines, pieces must weigh 16 ounces or more to be Parcel Post.³⁹

In contrast to BRPW, the DRPW data system properly classified these items as Standard Mail (A) in FY1998. Tr. 46/21526 (“Standard Mail (A) paid at Standard Mail (B) rates was recorded as Standard Mail (A). After this date [January 10, 1999], it was recorded as Standard Mail (B)”). See also Tr. 46/20668-72. For this reason alone, the hybrid BRPW/DRPW Parcel Post estimates of the Postal Service must be rejected in favor of the DRPW-only estimates.

2. Other Evidence Strongly Indicates that the PERMIT System Data Is Inaccurate.

The Postal Service’s hybrid BRPW/DRPW Parcel Post estimates are missing an important check on their reasonableness. In FY1998 and for the first two quarters of FY1999 there was no “unique revenue account associated with permit imprint Parcel Post to reflect actual Parcel Post revenues, and therefore there was no adjustment of the BRPW Parcel Post estimates to match actual permit imprint Parcel Post revenues.” Tr. 31/15038. See also Tr. 2/1047-48, 46/21218, 21219. This check is used for virtually all other permit imprint BRPW-based estimates. Tr. 31/15038. Indeed, in

38. Library Reference USPS-LR-I-37 Handbook F-75, “Data Collection User’s Guide for Revenue, Volume, and Performance Measurement Systems,” September 1997, at 3-95 (in evidence at Tr. 7/3134).

39. As we show at pages 89-92, *infra*, there are sound practical reasons for distinguishing between pieces weighing under one pound and pieces weighing more than a pound.

another context the Postal Service has heavily relied on the need for a trial balance revenue account check on BRPW estimates:

"A trial balance can be a useful tool for improving the quality of BRPW results by controlling to known amounts of revenue. . . . If a trial balance revenue account is available, it can serve as a control total for known revenue to which BRPW results can be tied For the trial balance controlled mail categories in the BRPW, the combined ratio estimator (of a total) takes advantage of the known revenue totals to correct the revenue estimate as well as to improve the volume estimates by exploiting the correlation between the revenue and volume, thereby reducing the sampling variance."

Tr. 46/21233.

The DRPW-only Parcel Post volume and revenue estimates were subjected to a similar, overall Book Revenue Adjustment in FY1998. Tr. 31/15039. The implicit Book Revenue Adjustment Factor in FY1998 was 0.94. *Id.* If that adjustment were applied to the BRPW portion of the Postal Service's hybrid Parcel Post estimates, the Postal Service's own volume and revenue estimates would be adjusted downward by 13.4 million pieces and \$35.2 million. Tr. 31/15107-08. That alone is a substantial decrease in the Postal Service's hybrid estimates.

Furthermore, the BRPW error checking process is seriously flawed. Tr. 31/15039-45. As Mr. Sellick concluded, "to be flagged as failing the [BRPW] revenue tolerance test it has to be a pretty egregious deviation." Tr. 37/17034-35. Under the BRPW error checking process, lighter Standard Mail (A) pieces could easily be mistakenly entered into the PERMIT System as Parcel Post and not be detected. Tr. 31/15040.

BRPW-PERMIT System data is taken from information on postage statements.

Tr. 31/15023. When the mail is presented, Postal Service bulk mail acceptance personnel are to verify the mailer-supplied information on the postage statement to make sure that it accurately reflects the characteristics of the mail that is actually presented. *Id.* at 15024. A postal employee then enters selected information from the postage statement into the PERMIT System data base. The PERMIT System data is then summarized in the Corporate Business Customer Information System ("CBCIS") database, which was "used as a source of aggregated PERMIT System Parcel Post data." Tr. 43/18792.⁴⁰

In FY1998, postage statement Form 3605-R was used to record the postage (revenue), volume, and weight information for permit imprint Parcel Post, Bound Printed Matter, and Priority Mail. Tr. 31/15024, 15050-51, 41/18117. The Postal Service introduced a new form, 3605-PR (see Tr. 31/15052-53), in 1999. Tr. 31/15024. That form "reduces the possibility that revenue, piece, and weight information for one category of mail . . . will be erroneously reported as belonging to another category. . . ." Tr. 31/15024. The Postal Service obviously took that step because "the new form is for one type of mail only (*i.e.*, permit imprint Parcel Post) and the old form was for up to three types of mail (*i.e.*, Parcel Post generally, Bound Printed Matter, and Priority Mail)."

40. It is particularly disturbing that all of the Postal Service's witnesses who testified on the hybrid system emphasized that they were not experts on the PERMIT System. Mr. Hunter, the Postal Service's chief BRPW witness, repeatedly volunteered that he is "not a PERMIT System expert." Tr. 2/946, 972, 973, 974, 991, 1050. Mr. Prescott, the Postal Service's BRPW rebuttal witness, also stated that he is "not a PERMIT System expert." Tr. 43/18785.

Tr. 31/15129. As a result, "mailer and postal acceptance personnel confusion and incorrect data entry are much less likely with the new form." Tr. 31/15129. Indeed, the Postal Service itself has acknowledged the existence of significant "keystroking errors." Tr. 43/18803 (explaining away a 55 million pound weight difference). Given the insufficiency of the Postal Service's BRPW error checks, Tr. 31/15039-45, such errors would likely escape detection.⁴¹

Mr. Sellick testified that "the information on certain Form 8125s . . . suggests that volume and weight information has been inaccurately entered into the PERMIT System." Tr. 31/15132. He noted that a "review of the produced Form 8125s shows instances in which the mail class indicated is Standard (B) DBMC Parcel Post whereas the piece weight demonstrates that the mail cannot possibly be Parcel Post but rather must actually be Standard Mail (A)." Tr. 31/15044. To make the situation worse, mailers often use outdated forms, thereby increasing the chances of confusion among postal personnel and data entry operators, which could lead to misclassifying the mail those forms cover. See Tr. 41/18109.

Internal control deficiencies at bulk mail entry facilities also raise serious concerns about the accuracy of the PERMIT System data. Postal Service witness Hunter testified that "[i]nternal control deficiencies are sometimes indicative of conditions which would allow inaccuracies in postage statements to go undetected" and

41. In the case of data entry errors which incorrectly enter Bound Printed Matter volumes as Parcel Post volumes, for example, the mistake would not result in an overcharge to the mailer. Thus, the mailer would have no reason to question the postage paid.

that "49 financial audits . . . reported some type of internal control deficiencies in the Business Mail Entry Unit." Tr. 46/20993. Significantly, Mr. Hunter noted that the "audit program in effect for BY 1998 did not require auditors to compare actual mailings presented at the BMEU to the respective postage statements." *Id.*

A substantial number of Postal Inspection Service audit reports for FY1998 "discuss 'business mail entry' and 'bulk mail acceptance' and the PERMIT System in general, which necessarily may include permit imprint Parcel Post." Tr. 31/15127. See USPS-LR-I-323 (in evidence at Tr. 31/15112-15). The audit reports "discuss systematic concerns (e.g., use of untrained personnel and non supervisory use of supervisor override codes)," Tr. 31/15127, and highlight concerns that inaccuracies in postage statement data may go undetected. These reports contain findings that call into question the reliability of the postage statement data. Tr. 31/15112-16.⁴²

The Postal Service has not done any credible study to ensure that the data taken off of postage statements was correctly entered into the PERMIT System database. Postal Service rebuttal witness Prescott referred in his testimony to a "study" "on the accuracy of the movement and roll-up of PERMIT transaction level data through CBCIS to the BRPW input file." Tr. 43/18793. That document was not sponsored by any witness, nor were the details underlying it provided. However, testimony about it indicates that *at most* only ten Parcel Post postage statements were checked. Tr. 41/18104. The "study" looked at a total of only 269 postage statements for all types of

42. At one facility, "Clerks in the BMEU estimate[d] 4 years, while other managers estimate[d] as long as 10 years, since they have done an adequate mail verification." *Id.* at 292.

mail. Tr. 41/18107. That is unusually small compared to the number of postage statements reviewed in the financial audits referred to by Mr. Sellick. See, e.g., USPS-LR-I-323 at page 316 (in evidence at Tr. 31/15112-15) (indicating that "1311 First Class, Standard-A and B mailing statements and CASS/MASS Summary Reports [were] reviewed . . .").⁴³

Even the limited number of audit reports produced by the Postal Service raise serious questions about the accuracy of postage statement data.⁴⁴ The Commission should not rely on a database developed from that information to justify substantial revisions to the volume and revenue estimates derived from a long-established regular data system such as DRPW in the absence of a far more thorough review than has been done in this case.

3. The Postal Service's Explanation of the Substantial Difference Between the DRPW-Only and the Hybrid BRPW/DRPW Estimates Is Speculative and Is Unsupported by Any Evidence.

The Commission asked the Postal Service point blank about the support for its substantial retroactive adjustment of the FY1998 Parcel Post volume and revenue estimates. The Commission there requested the Postal Service to identify the mail categories that were adjusted to offset the increase in Parcel Post volume and revenue.

43. Although the "study" did not attempt to examine whether information on postage statements accurately reflects mail as presented, it did note several problems in that respect, including improper verification of bulk mail. Tr. 41/18099-101.

44. The Postal Service refused to produce other such audits. United States Postal Service Objection to Interrogatory of United Parcel Service, UPS/USPS-12 (April 20, 2000).

Tr. 46/21543. The Postal Service responded with a non-answer -- that it was not possible "to isolate the changes in mail categories due strictly to the Parcel Post updates since other modifications occurred at the same time." *Id.*

The Postal Service later provided more non-answers in the rebuttal testimony of Mr. Prescott. He gave four reasons why the Postal Service prefers BRPW to DRPW. On cross-examination, he acknowledged that three of them did not apply to Parcel Post in 1998. Tr. 43/18814-17.⁴⁵ He was not sure whether the ability to determine the actual postage paid when presort and automation rate metered mail is metered at the lowest available rate applied to Parcel Post. Tr. 43/18817. *DMM* Section P013.1.5 makes it clear that this reason does not apply to Parcel Post. *DMM* Issue 55, ¶ P013.1.5, page P-13.

Mr. Prescott stated that "ODIS permit imprint Parcel Post volume data aligned well with the PERMIT System data, not the DRPW data." Tr. 43/18793. However, he did not provide any data to support his claim, let alone describe the method used to arrive at the data. Nor does he address how total ODIS Parcel Post volume -- rather than just the permit imprint portion -- aligns with the DRPW-only volume versus the hybrid BRPW/DRPW total volume.

The Postal Service tries to blame its DRPW data collectors for DRPW's alleged 50 million piece underestimation of Parcel Post volume and the associated revenue

45. As of January 10, 1999, when the DSCF and DDU rate categories were instituted, one of these three reasons began to apply to Parcel Post. Tr. 43/18817. However, that problem could be easily cured without resorting to the flawed BRPW approach merely by changing the endorsement requirements for DSCF and DDU mail. Tr. 43/18818.

understatement. Tr. 46/21031-32. But when the Commission asked the Postal Service about the frequency with which DRPW data collectors are trained, the Postal Service responded that "the percentage of data collectors who received training in FY1998 . . . should approach 100 percent." Tr. 46/21547. It went on to state, "During FY1998, every district was to conduct at least one day of statistical programs training each postal quarter for each person involved in data collection." Tr. 46/21547.

The joint use of BRPW and DRPW increases the possibility of double-counting. For most mail subclasses, RPW estimates are derived almost exclusively from either BRPW or DRPW. Tr. 31/15045. For Parcel Post, however, 33% of the total Parcel Post revenue estimate is derived from DRPW and 67% from BRPW. *Id.* The heavy reliance on both systems heightens the importance of ensuring that pieces and revenue counted in one system are not also counted in the other. Tr. 31/15046. A double-count of permit imprint Parcel Post can be avoided in only one way -- by excluding DRPW permit imprint Parcel Post observations from the DRPW data. *Id.* That in turn depends heavily on the ability of DRPW data collectors to identify correctly whether a particular piece of Parcel Post they sample was paid by permit imprint or not, and to correctly record the payment indicia on the piece. *Id.* If Postal Service witness Prescott is correct in his assessment of the ability of DRPW data collectors to identify different endorsements for different classes of mail, Tr. 43/18788-90, this additional reliance on the data collectors is unwarranted.

* * *

The Postal Service essentially asks the Commission to accept its hybrid BRPW/DRPW approach completely on faith. See Tr. 2/902 ("All I can say is that we collect the permit data. It's given to us and it's an input to my model") (Postal Service witness Hunter). Yet, the Postal Service itself was "hesitant to move immediately to use of the Parcel Post PERMIT System data in RPW . . . without knowing more about what might be causing the discrepancy." Tr. 43/18792. The Commission should likewise be hesitant to adopt the new approach as a basis for estimating Parcel Post revenue, pieces, and weight without knowing more than the Postal Service has grudgingly revealed on this record.

As Mr. Sellick noted, "[r]eliance on the hybrid BRPW/DRPW system . . . poses unacceptable risks and no benefits, particularly given the dramatic but unexplained increase in revenue, volume, and weight the new method generates." Tr. 31/15048. That is especially so since it is known with certainty that the BRPW-PERMIT System incorrectly counts an unknown amount of Standard Mail (A) pieces as Parcel Post.⁴⁶

Accordingly, the Commission should use the DRPW-only estimates of Parcel Post volume and revenues in arriving at its recommended Parcel Post rates.

46. PERMIT System data for Bound Printed Matter is also questionable. Volumes for Bound Printed Matter showed a steady upward trend from 1993 until 1998, Tr. 13/5299, when it declined from 522 million pieces in 1997 to 488.6 million pieces in 1998, a decrease of more than 33 million pieces. USPS-T-6, Table 16A at 172 (Tolley). The Postal Service has "no explanation whatsoever" for this volume decline. Tr. 30/14564. That the same postage statement form was used in 1998 for both Parcel Post and Bound Printed Matter (see Tr. 31/15050-51) increases the chances that data entry clerks may have erroneously entered Bound Printed Matter volume into the PERMIT System database as Parcel Post.

B. The Postal Service Has Also Double-Counted OMAS And Alaska Parcel Post Revenues.

In addition to the erroneous BRPW/DRPW Parcel Post estimates, the Postal Service has also double-counted OMAS and Alaska Parcel Post revenues. In particular, the Postal Service erroneously projects that Parcel Post OMAS and Alaska revenues will increase significantly from FY1998 to the Test Year even though the underlying volumes will decrease significantly. Tr. 38/17242 n.1.

OMAS and Alaska pieces are subsets of Parcel Post's rate categories. Because OMAS and Alaska volumes are assumed to decrease from FY1998 to the Test Year, the Test Year volumes of inter-BMC, intra-BMC, and DBMC parcels are higher than they otherwise would be. Tr. 25/11788. This in turn makes the Test Year revenues for inter-BMC, intra-BMC, and DBMC Parcel Post higher than they otherwise would be. Thus, to increase OMAS and Alaska revenues despite the OMAS and Alaska volume decreases is not only inconsistent, but it yields a clear double-count of revenues. Tr. 25/11788.⁴⁷

Mr. Luciani suggests a common-sense, easily instituted method for fixing the problem. Tr. 38/17257. Mr. Luciani's recommendations are unrebutted on this point, and the Commission should adopt his correction.

47. The Postal Service repeats this same error in its FY1999 derivation of Parcel Post Test Year revenues. Tr. 38/17242.

VI. PARCEL POST'S RATE DESIGN SHOULD NOT FAVOR BIG SHIPPERS AT THE EXPENSE OF SINGLE PIECE USERS.

The Postal Service's bias against the "ordinary mailer" is evident in its proposed Parcel Post dropshipment rates. As Mr. Luciani pointed out in his testimony (Tr. 25/11794), the Postal Service's 1.3% Parcel Post rate increase actually consists of rate increases of 10% for inter-BMC Parcel Post and 9.4% for intra-BMC Parcel Post -- the rate categories used by single piece mailers, Tr. 25/11794 -- while the rates for large mailers who dropship would virtually stay the same or actually decrease. USPS-T-36 at 13-14; compare USPS-T-36, Attachment I, page 6, with *DMM* Issue 54, ¶ R600.5.4, page R-21.

Since the Commission was created primarily to ensure that the Postal Service does not take advantage of ordinary mailers, the Commission should carefully scrutinize any proposals that lead to such a result.

A. Large Shippers Who Benefit From The Increased Value Of Service Which DDU And DSCF Entry Provide Should Bear A Portion Of The Parcel Post Rate Increase.

1. Sack Shakeout

The Postal Service asserts that all DDU-entry costs, including unloading and sack shakeout costs at the DDU, are avoided by DDU-entry parcels. In the R97-1 Decision, the Commission excluded the cost of sack shakeout from the DDU-entry cost avoidance. Tr. 25/11800.

There is no sack shakeout requirement in the *DMM*. Tr. 25/11800. Moreover, MTAC minutes suggest that at times the Postal Service "winks" at the regulations and

assists in unloading DDU-entry parcels. Tr. 25/11841. In rebuttal testimony, Amazon.com witness Clark and PSA witness Wittnebel testified that they were unaware of sacks being used by DDU-entry mailers and thus there would be no sack shakeout costs incurred by the Postal Service. Tr. 41/18045 (Wittnebel); Tr. 41/18138-39 (Clark). However, the Postal Service did not provide any information on the container profile of DDU-entry mail. Tr. 25/11800.

Moreover, Mr. Wittnebel's testimony on cross-examination indicates that the containers of unloaded DDU-entry parcels mailers leave on the dock necessitate an extra trip by a Postal Service employee to bring those containers into the parcel sortation area. Tr. 41/18050. Assuming a 60-second round-trip at \$30 per hour yields a cost of \$0.50 to deal with each container. There is no data available as to how many DDU-entry parcels on average are in these containers. Given that (1) there is no reliable data available about the container profile of DDU-entry parcels, (2) there is likely substantial additional time spent, and therefore cost incurred, to move the DDU-entry parcels from the dock of the DDU into the parcel sortation area, and (3) the Postal Service may at times assist in the DDU-entry unloading process, Mr. Luciani's recommendation that the 2.1 cents per piece of sack shakeout costs be excluded from the DDU cost avoidance calculation is a conservative adjustment that should again be implemented by the Commission.

2. Machinable Cost Difference

The Postal Service calculates DDU-entry mail processing cost avoidance using an average of the machinable and non-machinable cost savings off of DBMC-entry. Tr.

25/11801. This yields a double-count of savings, since a non-machinable surcharge is applied to non-machinable parcels entered at the DBMC based on the higher cost of handling non-machinable pieces. Mailers avoid paying the non-machinable surcharge when they enter non-machinable parcels at the DDU (*i.e.*, there is no non-machinable surcharge for DDU-entry parcels). Therefore, the DDU-entry cost avoidance should be based solely on machinable parcel savings since the mailer's avoidance of the DBMC-entry non-machinable surcharge captures the incremental cost savings of entering a non-machinable piece at the DDU. Tr. 25/11844.

PSA witness Glick argues that since the Postal Service is proposing to pass through only 35% of the DBMC non-machinable cost differential, one should derive the DDU-entry cost avoidance by including non-machinable costs not avoided. Tr.

41/18076-77. This confuses costing and ratemaking principles by calculating avoided costs incorrectly in order to compensate for an alleged passthrough deficiency.⁴⁸ Tr.

25/11985-86. If the passthrough of the DBMC non-machinable cost differential is a concern, one should simply address the amount of that passthrough.

Accordingly, Mr. Luciani's recommendation to calculate the DDU-entry cost avoidance solely on the machinable cost avoidance should be adopted by the Commission.

48. Because of the 35% passthrough of the DBMC non-machinable cost differential, Mr. Glick argues that while non-machinable DDU-entry parcels have an overstated effective discount of 5.7 cents per piece, non-machinable DDU-entry parcels have an understated effective discount of 60 cents per piece. Tr. 41/18077. Given that 95% of parcels are machinable (USPS-T-26, Attachment J), this still yields an average overstated effective DDU-entry discount of 2.4 cents per piece (95% times 5.7 cents minus 5% times 60 cents).

3. Cubic Feet Per Piece for DDU-Entry and DSCF-Entry Parcels Should Be Used to Determine DDU-Entry and DSCF-Entry Costs.

In constructing the costs for DDU-entry and DSCF-entry Parcel Post, Postal Service witness Plunkett assumed that DSCF-entry and DDU-entry parcels have the same cubic feet per piece as intra-BMC parcels. He did so despite his admission that the physical characteristics of DSCF-entry and DDU-entry parcels should more closely approximate those of DBMC-entry parcels rather than intra-BMC parcels. Tr. 13/5017.⁴⁹

As Mr. Luciani testified, DDU-entry and DSCF-entry Parcel Post cubic feet per piece should be based on the cubic feet per piece of DBMC-entry Parcel Post. Tr. 25/11802. Since DBMC-entry parcels are bigger than intra-BMC or inter-BMC parcels, parcels entered at the DSCF or at the DDU will incur higher transportation costs for the transportation they use than non-dropshipped parcels using those same transportation legs. Ms. Daniel's final adjustments use this approach.

In using the FY1999 data in its cost models, the Postal Service uses the same cubic feet per piece for DBMC-entry, DSCF-entry, and DDU-entry parcels. USPS-LR-I-469, Attachment L (in evidence at Tr. 46/21158). The Commission should do likewise.

4. Alaska Air

In its initial filing, the Postal Service distributed the volume variable share of Alaska air costs only to intra-BMC and inter-BMC Parcel Post on the basis that only

49. In the absence of data to the contrary, the most reasonable approach is to expect that all dropshipped mail will have similar physical characteristics. In fact, Mr. Plunkett himself uses total DBMC volume to estimate the volume of DSCF-entry and DDU-entry parcels. Tr. 25/11802.

those rate categories are offered in Alaska. However, DSCF-entry and DDU-entry rates are offered in Alaska. Tr. 13/5202, 25/11803. Thus, a share of Alaska air costs should be allocated to DSCF-entry and DDU-entry parcels. Tr. 25/11803.

PSA Witness Glick argues in his rebuttal testimony that allocating a share of the volume variable Alaska air costs to DSCF-entry and DDU-entry parcels would be a "double-count." Tr. 41/18082. However, Mr. Glick apparently has not reviewed Postal Service witness Eggelston's testimony, in which she quite clearly states that all volume variable Alaska air costs were attributed to inter-BMC and intra-BMC parcels, and none to DBMC parcels. USPS-T-26, page 25. Since DSCF-entry and DDU-entry transportation costs are based directly on DBMC-entry transportation costs, USPS-T-26 at 27, Attachment N, the DSCF and DDU rate categories have not been allocated any of the volume variable Alaska air costs in the Postal Service's original analysis.

In its FY1999 update of Parcel Post costs, the Postal Service allocates a share of Alaska air costs to DSCF-entry and DDU-entry parcels. USPS-LR-I-469, Attachment M, page 3 (modified version of USPS-T-26, Attachment M) (in evidence at Tr. 46/21158). The Commission should also assign a share of the volume variable Alaska air costs to DSCF-entry and DDU-entry parcels, as Mr. Luciani has recommended and as the Postal Service has done in its FY1999 submission.

5. The Postal Service's Proposed Passthroughs for the DDU and DSCF Worksharing Discounts Should Be Reduced.

DDU-entry Parcel Post is attracting substantial volumes, Tr. 41/18179-82, most likely because parcels entered at the DDU apparently are delivered the next day 97% of

the time. Tr. 5/1912. See also Tr. 5/1874 (Postal Service instructions that "It is essential that we provide timely and accurate delivery once [DDU parcels] are in our control"). Under these circumstances, from a value of service standpoint there is little or no difference between Priority Mail and DDU Parcel Post. Tr. 25/11805. In short, Parcel Post DDU-entry is essentially equivalent to Priority Mail once it reaches the DDU.

However, unlike Parcel Post, Priority Mail makes a significant contribution to institutional costs. Tr. 25/11805-06. Unless DDU-entry Parcel Post makes a more significant contribution, the Postal Service may end up losing significant contribution to institutional costs. Tr. 25/11959. In his testimony on behalf of APMU, Dr. Haldi raises this very concern. Tr. 25/11516-17.⁵⁰

To ameliorate this situation, Mr. Luciani has recommended applying the Priority Mail markup to the cost of DDU-entry pieces in determining the appropriate passthrough for DDU avoided costs. Tr. 25/11806. The passthrough needed to provide a markup on DDU-entry costs similar to that for Priority Mail is approximately 50%. *Id.*

Mr. Glick argues that the Commission should pass through nearly 100% of the DDU cost avoidance because in Docket No. R97-1, "the Commission reject[ed] a blanket recommendation of low passthroughs . . ." and adopted a DDU discount of 72 cents, or nearly 100% of the DDU cost avoidance of 72.4 cents per piece. Tr.

50. However, in his later rebuttal testimony on behalf of Amazon.com, Dr. Haldi criticizes Mr. Luciani and Dr. Sappington for making this same point. Tr. 44/19537.

41/18082-83, citing R97 Decision at 1/482, ¶ 5653. However, the rapid growth of dropshipped volume, the next day delivery service DDU-entry is providing to mailers, and the fact that, under the Postal Service's proposal, DDU-entry rates would hardly change at all while single piece Parcel Post users would experience rate increases of up to 10% (for inter-BMC Parcel Post) changes the calculus.

The maximum passthrough that should be adopted by the Commission is 80%, the effective passthrough that results implicitly from the rate constraints proposed by Postal Service witness Plunkett. Tr. 25/11806. Even that penalizes single piece mailers and risks loss of contribution. Mr. Luciani's approach should be adopted instead.

As to DSCF-entry, Mr. Plunkett's passthrough proposal yields a paltry DSCF-entry rate increase of only 0.7%. Tr. 13/5010. Again, the pattern is clear: the rate increase for Parcel Post is borne almost entirely by single piece users, while big shippers pay less for better service. Instead, as recommended by Mr. Luciani (Tr. 25/11807), the DSCF-entry passthrough should be set mid-way between the DDU-entry passthrough and the DBMC-entry passthrough. Tr. 25/11807.

B. DBMC-Entry Rates Are Incorrectly Calculated.

1. DBMC Cost Avoidance Is Overstated.

The Postal Service uses mail flow models to derive all Parcel Post mail processing cost avoidances except that of DBMC-entry. Tr. 25/11798. To derive the DBMC-entry mail processing cost avoidance of 55.7 cents per piece, the Postal Service uses IOCS data to determine the total amount of Parcel Post non-BMC outgoing costs

and divides by non-DBMC Parcel Post volume to determine the average cost avoided by DBMC-entry parcels. Tr. 25/11796-97.

This methodology, first developed in Docket No. R90-1, is now yielding puzzling results (e.g., avoided costs 48% higher than the Postal Service derived in Docket No. R97-1), in part because, as Mr. Luciani testified, according to IOCS there is a significant amount of non-BMC outgoing costs incurred by DBMC parcels. Tr. 25/11796-97. Counting costs incurred by DBMC-entry parcels as avoided by DBMC-entry parcels obviously must be rectified.

The Postal Service's technique relies on Basic Function data in IOCS that is no longer used in the Cost Segment 3 cost allocation process. Tr. 25/11878. Mr. Luciani proposes using the mail flow models presented by Ms. Eggleston to develop DBMC-entry cost avoidance. Tr. 25/11797. Because the mail flow models do not currently cover the origin AO, he augments the mail flow model with a targeted use of the Postal Service's method to derive a DBMC-entry mail processing cost avoidance of 35.8 cents per piece. Tr. 25/11798-99.

In his rebuttal testimony, PSA witness Glick suggests a "middle ground" which attempts to correct the error found by Mr. Luciani by comparing the IOCS non-BMC outgoing costs incurred by DBMC parcels to those incurred by non-DBMC parcels. Tr. 41/18074. However, Mr. Glick is silent on how DBMC parcels -- which by definition are entered at the BMC -- can incur *any* non-BMC outgoing costs. Without an explanation

of this seemingly anomalous IOCS data, reliance on the mail flow models is a far superior approach to determining DBMC-entry cost avoidance.⁵¹

In the Postal Service's FY1999 update of the Parcel Post cost models, the IOCS-based top-down approach yields another inexplicable rise in Test Year DBMC mail processing cost avoidance.⁵² On the other hand, the Test Year cost difference between DBMC and intra-BMC Parcel Post using the mail flow models remains similar to that determined on the basis of the FY1998 data.

The Commission should apply the work flow models to derive the DBMC cost avoidance, as recommended by Mr. Luciani, and adopt a DBMC-entry mail processing cost avoidance of 35.8 cents per piece.

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51. Mr. Glick's "middle ground" also fails to take into account two adjustments to the top-down methodology that were recommended by the Commission in Docket No. R97-1 and adopted by Ms. Eggleston in this proceeding: (1) deducting for the amount of non-BMC outgoing costs incurred when the ASF acts as a BMC, and (2) deducting non-BMC outgoing platform acceptance costs. USPS-LR-I-469, Attachment F (modified version of USPS-T-26, Attachment F) (in evidence at Tr. 46/21158); USPS-T-26, Attachment F. Incorporating these adjustments lowers the DBMC-entry cost avoidance Mr. Glick calculates.
52. The Test Year DBMC-entry mail processing cost avoidance increases from 55.7 cents per piece to 73.7 cents per piece. USPS-LR-I-469, Attachment F (modified version of USPS-T-26, Attachment F) (in evidence at Tr. 46/21158). The differential in the Test Year costs in the mail flow models between intra-BMC and DBMC machinable parcels increases only from 24.9 cents per piece to 25.6 cent per piece. USPS-LR-I-469, Attachment A (modified version of USPS-T-26, Attachment A) (in evidence at Tr. 46/21158).

2. The Postal Service's Proposed Rate Design for DBMC-Entry Parcels Departs From the Commission's Established Approach.

As it did in Docket No. R97-1, the Postal Service derives its proposed DBMC-entry discount rates by applying a markup factor (21%) to its estimated DBMC-entry transportation cost savings per piece. Tr. 13/4970. The result is that the discount for DBMC parcels consists not only of 100% of the costs avoided by those parcels, but also includes a reduction in the contribution to institutional costs which those parcels would otherwise make. Tr. 25/11804, 13/4970. In other words, large volume business shippers not only get the benefit of the cost savings achieved by the Postal Service, but also pay a smaller share of institutional costs, which must then be paid by smaller shippers and single piece Parcel Post users.

In the past, the Commission has rejected this approach for worksharing rate categories such as DBMC, R97 Decision at 1/489, and it should do so again. DBMC-entry rates should be developed by deducting from the intra-BMC rates the estimated transportation cost savings between DBMC and intra-BMC parcels. Tr. 25/11804. Similarly, the passed through avoided DSCF-entry and DDU-entry transportation costs should be subtracted from the DBMC-entry rates.

C. The Postal Service's Proposal To Reduce The Minimum Weight For Parcel Post Should Be Rejected.

Postal Service witness Plunkett proposes "removing the existing one pound minimum weight requirement for pieces otherwise mailable at Parcel Post rates." USPS-T-36 at 12. He does not propose a new rate category or rate cell. Rather, "the

lowest rate in each category would be applicable to all pieces weighing up to two pounds." *Id.*

The only justification the Postal Service offers for this change is contained in three sentences in Postal Service witness Mayes' testimony. Ms. Mayes states that it "may make mail preparation simpler for some mailers who desire to ship a variety of merchandise of varying weights as Parcel Post and take advantage of the worksharing opportunities afforded by the rate schedule without splitting the shipment into separate subclasses." USPS-T-32 at 42.

The Postal Service has provided no analysis of the impact this change will have on costs, revenues, volumes, or any other factor, such as the operational considerations involved in combining very small, under one pound packages with much heavier Parcel Post shipments. The Postal Service's failure to address any of these issues is fatal to its proposal.

Particularly troublesome is the absence of any analysis of the impact of this proposed change on Priority Mail. Much of Priority Mail weighs less than one pound. In fact, in 1999 more than 172 million Priority Mail pieces, or approximately 15% of total Priority Mail volume, weighed more than 13 ounces but less than a pound.⁵³ USPS-LR-I-250 (in evidence at Tr. 7/2784). Most or all of these pieces could shift to Parcel Post if Mr. Plunkett's proposal is adopted. That would undoubtedly have a significant impact

53. These figures exclude the 215 million pieces of Priority Mail that weighed 13 ounces or less, most of which could have been sent as First Class Mail. Tr. 31/15254. We assume that the mailer's choice to send these pieces as Priority Mail rather than as First Class Mail indicates that they would not be sent by Parcel Post.

on both Priority Mail and Parcel Post, not to mention the significant reduction in contribution to institutional costs that would result, given Parcel Post's low cost coverage. That impact should be investigated before this proposal can be seriously considered.

Moreover, the record establishes that there are meaningful and substantial cost differences between the heavier Parcel Post parcels and Standard Mail (A) parcels that weigh less than a pound. See, e.g., USPS-T-26, Attachment K, "Summary of Cube-Weight Relationship Results"; Tr. 39/17837-38 (larger parcels take significantly longer -- about 14 seconds more, on average -- to deliver than small parcels). Indeed, even with the Standard Mail (A) parcel surcharge, the cost of under one pound Standard Mail (A) parcels is substantially less than the lowest cost for Parcel Post pieces.

The Commission has long held that two types of mail with substantial differences in cost or demand should not be classified together. *Mail Classification Schedule*, 1995, Docket No. MC95-1, Opinion & Recommended Decision at III-10, ¶ 3025 (January 26, 1996). The Postal Service's proposal violates this prescription.

Finally, it is not at all clear that this proposed change is either needed or wanted by mailers. There is no evidence of how many mailers will benefit, or by how much. In fact, there is no analysis whatever of the statutory classification or ratesetting criteria.

The minimum weight for Parcel Post has been one pound ever since Parcel Post was created in 1913. The Postal Service has not provided any support for changing this long-standing requirement. Given the total lack of analysis of the operational, cost, revenue, and volume implications of the proposal, it would establish bad precedent to

allow this change without any explanation or meaningful scrutiny. In short, Mr. Plunkett's proposal should be rejected.

VII. THE 2.5% CONTINGENCY REQUESTED BY THE POSTAL SERVICE SHOULD BE APPROVED.

There has been a great deal of discussion concerning the appropriateness of the Postal Service's proposed contingency allowance of 2.5%. However, the 2.5% figure is certainly not out of line when compared to contingency provisions previously approved by the Commission.

Furthermore, actual FY1999 data show substantial discrepancies in attributable cost per piece compared to the FY1999 estimates originally submitted by the Postal Service in the case of some services -- a shortfall of more than 6% for Priority Mail, for example. This strongly militates in favor of the Postal Service's proposed contingency of 2.5%, especially since the attributable cost per piece discrepancies are for only the first year of the three-year rollforward process. Likewise, too small of a contingency allowance creates a real risk that those services with a low cost coverage (such as Parcel Post) and those services subject to considerable cost uncertainties (like Priority Mail, in light especially of the decision of the Court of Federal Claims on the Postal Service's PMPC contract dispute with Emery, for example) will fall below attributable costs or will not contribute their fair share to institutional costs.

The Commission should not run the risk that its recommended rates will fall short of the level needed for the Postal Service to recover its costs in the Test Year. The most effective way to guard against that possibility is to approve the reasonable contingency allowance of 2.5% requested by the Postal Service.

CONCLUSION

WHEREFORE, for the reasons set forth above, United Parcel Service respectfully submits that the Commission should:

(1) Reject the Postal Service's flawed proposal to reduce substantially the attribution of mail processing labor costs, reaffirm the Commission's well-established attribution of such costs, and distribute those costs to the classes of mail on the basis of the MODS-based approach adopted by the Commission in the last case as modified by the Postal Service in this case;

(2) Mark up all of the costs attributable to each class of mail, including the volume variable and the specific fixed costs of each class;

(3) Revise the Postal Service's treatment of purchased transportation costs to (a) distribute the premium costs of its dedicated air networks to Priority Mail as well as to Express Mail, and (b) allocate the cost of empty space in purchased highway transportation on a basis that better reflects what mail gives rise to the need for the total capacity purchased;

(4) Improve the distribution of attributable City Carrier elemental load costs to parcels and the attribution of advertising costs to Priority Mail, Parcel Post, and Express Mail;

(5) Reject and correct the Postal Service's estimates of Parcel Post revenue, pieces, and weight, including (a) its ill-considered reliance on the hybrid "BRPW/DRPW" approach in place of the long-used DRPW method and (b) its improper treatment of OMAS and Alaska volumes and revenues;

(6) Adopt cost coverages for Priority Mail and for Parcel Post that are more consistent with the statutory goal of protecting captive customers rather than mailers with readily available alternatives;

(7) Correct the Postal Service's Parcel Post rate design errors; and

(8) Approve the Postal Service's proposed contingency allowance.

Respectfully submitted,



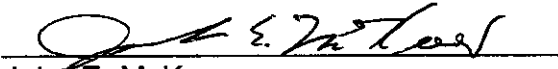
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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document by first class mail, postage prepaid, in accordance with Section 12 of the Commission's Rules of Practice.


John E. McKeever
Attorney for United Parcel Service

Dated: September 13, 2000
Philadelphia, Pa.

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